Avoid Earnings Surprises after closing an M&A acquisition

To structure and communicate M&A deals effectively, companies must consider the appropriate level of analysis required to provide earnings guidance to analysts and investors. Benchmarking estimates should not be the only data considered when assessing the accretive/dilutive impact of a transaction. Thoroughly assessing the impact of acquisition accounting rules on earnings during the due diligence period provides the most meaningful analysis.

Consider the following scenario: You are a CFO or controller of a publicly traded company. Your CEO is about to announce an acquisition and plans to tell the "Street" the potential earnings impact of the deal. How comfortable are you with what he or she is going to say to those analysts who closely cover your company's stock?

When getting ready to announce a deal, ask yourself: Has the accretion/dilution analysis been vetted? Have such items as intangible asset amortization, restructuring charges, conforming accounting policies, etc., been appropriately considered? If the answer to any one of these questions is “no,” certain pitfalls may be looming down the road.

Not only that but also in many cases the person who can answer these questions is not even a part of the M&A team leading the deal.

Fortunately, they can be avoided with a Pre-Purchase Price Allocation analysis (“Pre-deal PPA”) since the due diligence period. This will allow the CFO or controller to get ahead and have an assessment of the potential impact of acquisition accounting rules before the Deal has close while still having the access to and support from the M&A team who is driving the deal.

Recognizing the danger zones

One danger zone is increased depreciation and amortization related to recording the acquired net assets at fair value. The other relates to potential charges resulting from the introduction of new accounting standards (i.e. IFRS 16). Both have the potential to create unwelcome surprises after the deal has closed.

For earnings per share (EPS) sensitive companies, a shift has already occurred toward assessing the earnings impact of the potential transactions during the due diligence phase, however, investment bankers and other advisors tend to estimate the impact of acquisition accounting using “rules of thumb” or by undertaking high-level benchmarking analyses. While such information may serve as a “ballpark” figure, those estimates may not be enough for communicating effectively the expected earnings impact of

planned acquisitions. “Close” only counts in horseshoes, analysts and investors actually have a different view when it comes to earnings impact.

How to avoid earnings surprises during due diligence

By performing a Pre-deal PPA analysis, which can often be efficiently leveraged for a post-deal compliant valuation, companies can mitigate the risk of having to reformulate financial statements should the post-deal acquisition accounting results differ significantly from any preliminary amounts recorded.

Understand the limits of benchmarking

Many companies historically assessed the post-acquisition earnings impact of a potential deal by estimating the fair value of intangible assets without significant analysis. These estimates, which were largely driven by “benchmarks,” were based on the allocation of a percentage of the purchase price to amortizable assets recorded in prior transactions where publicly available information existed.

This approach is easy to apply but loaded with potential pitfalls. For example, consider the post-acquisition accounting for certain balance sheet accounts such as Right of Use Assets and Lease Liabilities. These items, which may not be factored into data collected through a benchmarking study that is inclusive of transactions closed prior to 2019, could result in an unexpected EPS impact post-acquisition.

This is not to say that a benchmarking study is not useful when estimating the post-acquisition earnings impact of a planned acquisition. Benchmarking may provide useful insights when assessing the accretive/dilutive impact of a transaction being considered, but it should not be the only data point considered.

Benchmarking can be useful if done with care and the limitations are appropriately considered, especially when timeframes are extremely compressed. However, companies should carefully consider the appropriate level of analysis required when estimating the post-acquisition EPS impact of a planned acquisition.

One of the perils of benchmarking is that prior transactions used to benchmark may not be comparable to the transaction being considered. In such instances, the amounts recorded in acquisition accounting could differ significantly from expectations initially communicated to investors.

Determine the appropriate level of analysis and choosing a better approach

In cases where a benchmarking exercise is not appropriate, a more in-depth preliminary valuation analysis should be undertaken. This assessment would ascribe preliminary values to the key tangible and intangible assets, which would provide a more meaningful and reliable result.

Such in-depth preliminary analysis is designed to partially replicate a “post-deal” compliance-focused valuation exercise. During this process it is not uncommon to face lack of complete information, access to target management, and time constraints, hence, calculations in the pre-acquisition analysis will depend on key assumptions.

However, these potential limitations can be overcome by integrating a valuation adviser into the due diligence team. An embedded valuation adviser can offer significant improvements to and insights into the overall deal process, especially where information is fairly limited. In fact, most key intangible assets, liabilities, and acquisition accounting issues that impact post-acquisition EPS can be extracted from very few key items which are easily accessible through an integrated diligence team (e.g. buyer’s deal model, summary of the target’s intellectual property and summarized fixed asset ledgers with historical cost and net book values).

Although the results of such a Pre-deal PPA exercise will not substitute a full post-deal PPA for financial reporting or tax purposes (due to the limitations noted earlier), this valuation effort is typically a more refined and well thought out approach than a simple benchmarking study. It can also be leveraged in the work performed for a post-transaction valuation, or one that can be used for pro-forma purposes in financing documents or communications with shareholders.

Other acquisition accounting related issues

Valuation expertise is required to properly apply acquisition accounting, but that is only one component of the exercise. Acquisition accounting expertise should also be integrated into the due diligence and valuation exercise so that a thorough analysis of significant factors that may impact post-deal earnings are considered. Two often overlooked technical issues, such as amortization methods and deferred revenue, can mean a big difference after the deal closes.

Conclusion

Assessing the impact of contemplated transactions using benchmarking studies introduces risk that the amounts recorded in acquisition accounting may differ significantly from expectations communicated to key stakeholders. The factors cited on this paper highlight the importance of understanding the details behind amounts recorded in prior transactions that serve as a basis of a benchmarking analysis. Failure to do so may result in a surprise in post-acquisition EPS, and in the most extreme case, in a dilutive impact to EPS when the transaction was initially thought and communicated to be accretive.

Therefore, consideration of supplementing benchmarking studies with a more robust exercise integrated with due diligence procedures should be conducted to mitigate future surprises.

There are many benefits of integrating transaction services professionals that specialize in acquisition accounting and valuation into a due diligence team. By doing so, companies will be better positioned to assess the earnings impact of potential acquisitions and communicate such impacts to stakeholders with confidence.

To have a deeper conversation about how this subject may affect your business, please contact:

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