

How New Rules Affect The M&A Valuation Process

Corporate governance and accounting reforms prompt companies to use third-party specialists for some m&a work

By Joan Harrison

In the wake of corporate governance and other business scandals, accounting industry oversight remains a hot-button issue. Last summer the SEC issued final rules concerning auditor independence under



Sarbanes-Oxley — prohibiting accounting firms from performing nine types of services for an audit client, including fairness opinions and valuations. As a result, companies increasingly are using third-party firms to perform these services.

Mergers & Acquisitions recently caught up with some valuation specialists to get their take on how new governance and accounting rules are impacting the m&a valuation review process.

The specialists overwhelmingly agree that because of Sarbanes-Oxley, boards are paying much more attention to acquisitions, and increasingly are relying on the services of third parties to help with various dealmaking functions — largely due to their auditor's urgings.

"When Sarbanes-Oxley first came down, many companies were reluctant to use firms like ours because they thought they could do the work inter-

nally, and thought there still was some give-and-take with the auditors. Now the auditors are really driving it, saying that they're not going to rely on companies' internal work papers, and requiring companies to get the work

done by a third party," says Christopher Kramer, a Managing Director at Strategic Equity Group.

Auditors may be precluded from doing m&a valuations, but they still review pricing models and evaluate whether the assumptions used are reasonable and whether the model is appropriate given the company's specific circumstances, notes Bryan Browning, Senior Vice President and Professional Services Manager at Valuation Research Corp. So auditors need to have an in-depth understanding of the methods and assumptions used by valuation specialists.

The function of reviewing business cases, which includes business plans, synergies, financial projections, and the pricing analysis, is where a number of companies are drawing the line, says Phil Clements, Executive Vice President at Standard & Poor's Corporate Value Consulting. "The due diligence that

goes into a target company review generally is rolled into the business case, and what you're going to see, I think, is that an increasing number of firms will use third parties to do that work. The big issue with will be the company's ability to be efficient in the deal process, so you won't have two experts fighting with one another, which could cause some ripples in the process."

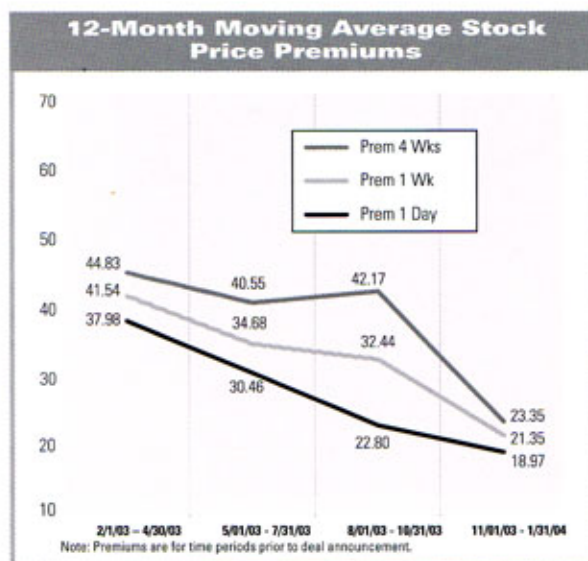
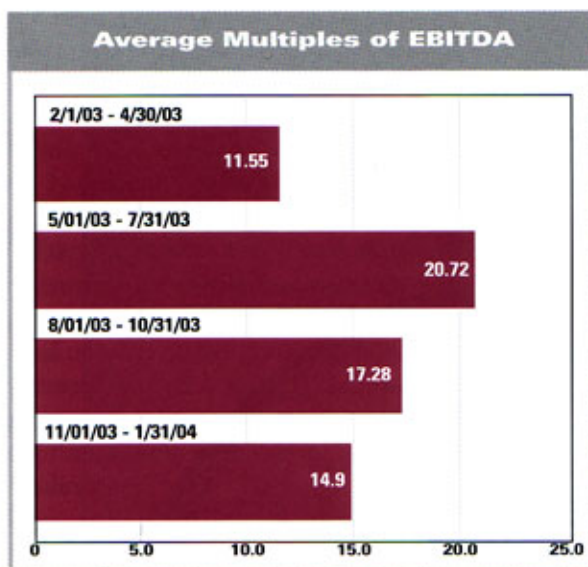
Will the trend toward using third-party valuation experts affect deal pricing in any way?

Sarbanes-Oxley rules have sparked heightened scrutiny of all aspects of the deal process, and companies now more carefully document due diligence, negotiation, and valuation, and accounting work that goes into a transaction, says Robert Reilly, a Managing Director at Willamette Management Associates. The accounting treatment of the purchase price and its impact on the acquirer's earnings after deal closing, especially, is under closer examination than it used to be, he adds.

Kramer agrees that companies are more mindful of the need to document the process for arriving at the purchase price. "Purchase price allocation is a big issue, as a result of accounting rule changes," he adds. "We've been involved in a couple of deals where we've been asked to analyze the purchase price to determine what the impact on the company's earnings would be post-deal. That has influenced what they were willing to pay. This is all work that has arisen as a result of FAS 141 and 142."

Experts say that engaging a third-party valuation firm to do a purchase price allocation can cost a public company upward of \$50,000, depending on the deal size. Plus, FAS 142 requires impairment testing at least once a year — an added cost to the deal process. ■

Pricing Softens In M&A Deals



Softer pricing ruled the m&a market in the second half of 2003 and early 2004. The contraction in multiples of target company EBITDA reflects a balance in the supply of targets and demand on the buy side, which, dealmakers say, is laying a foundation for an m&a rebound. The supply-demand mesh is coalescing around a pricing equilibrium. Despite the contraction in multiples, pricing still remained at a level that pressures buyers into paying full prices to buy quality targets.

EBITDA multiple movements tracked the pricing for public firms, as measured by premiums over stock prices, which declined sharply. Besides the supply-demand match-up in the m&a market, premiums dropped because of the strength in stock prices themselves. ■