

## VALUE ADDED™ Winter, 2002/2003

### Negotiating Strategies to Create the Best Deal

There are different styles of negotiating a deal. Some of the most useful and realistic ways are fairly simple but they can be easy to overlook while in the line of fire. As such, below is a list of ten things that help create value for a deal.

#### 1. Be confident

Preparation creates confidence. It is important to know and understand all relevant material and its potential impact on a deal. Anticipate issues that could arise in the course of negotiations and prepare your response.

#### 2. Have a higher asking price than you expect to receive

The purpose of negotiation is to achieve a win-win situation for all parties. By asking for more than you expect to receive, you are establishing a perceived value to the other side. This concept provides room to compromise later if necessary and still achieve a transaction that meets expectations. It gives the other side the feeling that they have won an issue when expectations are lowered.

#### 3. Set timetables

Deals usually take time to complete. Delays are not uncommon. Give the other side a timeframe at which certain conditions are to be met. It can help keep a deal on track and push it forward.

#### 4. Pick your battles

There are times in any negotiation to draw the line and other times to be flexible. Make a list of the issues most important to you where there is little leeway. Be flexible on the less relevant issues. Always keep the end goal in mind and be careful in picking your battles.

#### 5. Be personal and let others get to know you

In order to create better lines of communication, it is helpful to let the other side get to know you and for you to get to know them. This helps to bring things in focus. It can also create a feeling of trust among the parties.

#### 6. Try not to burn bridges

Negotiations can be very tense. Avoid emotional interference. Always try to leave the door open if and when negotiations stall. It is not uncommon for a party that has left a deal to pick it up again later.

#### 7. Recognize different personalities

You may be dealing with people who are difficult and test your patience. Be careful in your reactions. Do not take things personally and be flexible (within limits).

#### 8. Be honest but firm

Know the facts and do not overstate them. If you do not know an answer, advise the other side that you will get back to them with the correct information.

#### 9. Do not take shortcuts

Some take shortcuts to move the process along. Often, this results in avoidable mistakes.

#### 10. Do not be afraid to lighten things up with humor

There are stressful moments in all deals. Appropriate humor helps to lighten the mood and move the process along.

Keep these ten simple but important hints in mind as you go through the negotiation process.

#### Employee Options

Current accounting rules do not require companies to record any expense when they grant their employees stock options. However, when an employee exercises the option, the company can expense, for tax purposes, the difference between the exercise price and the market value of the stock. This expense does not have to be recognized for financial reporting purposes (other than a footnote to explain the difference between taxes shown for financial reporting purposes and for income tax purposes.)

APB Opinion No. 25, issued in October 1972, states that compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay. The measurement date is defined as the first date on which are known both: (1) the number of shares than an individual employee is entitled to receive; and (2) the option purchase price, if any. Therefore, a corporation issuing at the money options (options with an exercise price that equals current market price) does not recognize any compensation cost for the options. The Financial Accounting Standards Board, "Accounting for Stock-Based Compensation," Exposure Draft in June 1993 proposed that a modified version of an option pricing model (fair value method) be used to value employee stock options and that this value be recognized as an expense on the grant date. Negative public reaction to the proposal resulted in FASB postponing implementation. When the Statement of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" (FAS 123) was issued in October 1995 it encouraged companies to adopt reporting the fair value of the consideration. However, it allowed firms to continue to account for option expense under APB Opinion No. 25, provided their financials included pro-forma statements indicating the effect the option grants would have had on their earnings had they adopted FAS 123.

FAS 123 suggests using an option pricing model, which takes into account: (1) the option's exercise price; (2) the expected life of the option; (3) the current price of the underlying stock; (4) the expected volatility of the underlying stock returns; (5) the expected dividends on the underlying stock; and, (6) the risk free rate over the life of the option. However, following these guidelines blindly would tend to overstate the value of a compensatory option, as it does not consider: (1) vesting or restrictions on transfer of the option; (2) lack of an active market for compensatory options; or (3) other restrictive conditions. According to FAS No. 123, nonpublic entities are permitted to exclude the volatility factor in estimating the value of their stock options, which results in measurement at minimum value.

Generally accepted modifications of an option pricing model to adjust for such factors as the non-transferability of employee stock options are described in FAS 123. The standard option pricing models were designed to estimate the value of transferable stock options. Transferable stock options are more valuable than nontransferable options because they can be sold, while nontransferable options may only be exercised. To adjust for the non-transferability of employee stock options it may be necessary to estimate the expected life of the option at a shorter length of time than its maximum term (expiration date) when developing inputs for an option pricing model. This adjustment would lower the value of the option, as the holder would have less time to benefit from favorable stock price movements.

There are frequently terms, restrictions and conditions attached to employee stock options that will affect their value relative to publicly traded options. To capture the effects of these factors on the value of the option, adjustments to the standard option pricing models must be made.

There are several revenue procedures that offer guidance for valuing stock options. Revenue Procedure 98-34 provides safe harbor valuation guidelines for non-publicly traded compensatory stock options on stock that, at the valuation date, is publicly traded on an established securities market. Revenue Procedure

2002-13 also provides guidance to valuing compensatory options on publicly traded or non-publicly traded stock and is purported to be based on the Black-Scholes Option Pricing Model. Both procedures state that options may be valued using methodology consistent with generally accepted accounting principles, such as FAS 123.

Currently, investors are demanding more transparency in financial statements. Several large companies have adopted the fair value method of accounting for stock-based compensation. An exposure draft for an amendment to FAS 123 was issued on October 4, 2002. This proposed statement would require new disclosures that would provide greater clarity of the effect of stock-based compensation on reported results. It also permits two additional transition methods for firms that adopt FAS 123 in accounting for stock based compensation.

If you have any questions, feel free to contact us.

Purchase Price Allocations

Statement of Financial Accounting Standards No. 141, Business Combinations ("FAS 141"), drew a sharp distinction between goodwill and other intangible assets acquired in a transaction. As a result, the allocation of the purchase price to the various assets acquired has taken on new urgency for both public and private acquirers. The purpose of this brief article is to address four critical questions that are likely to be asked by the members of finance departments at the acquiring company.

1. Does my company really need to perform a purchase price allocation for acquisitions?

Yes. Allocations have actually been required since APB Opinions 16 and 17. However, prior to the issuance of FAS 141 (and 142), there was really no difference in the manner in which goodwill or other specifically identifiable intangible assets were treated subsequent to the acquisition. For this reason, readers of financial statements generally observed a single line item, "Goodwill & Intangibles" on the balance sheet, to which a uniform amortization schedule was applied. Given the disparate amortization treatment for goodwill and other intangibles under the new standards, the FASB has indicated that specific allocations of the purchase price are necessary.

As noted by the FASB's Emerging Issues Task Force in Topic No. D-100, "The Board believes that many entities concluded that their financial statements were prepared in accordance with generally accepted accounting principles, in all material respects, even though intangible assets acquired in a business combination were not recognized and accounted for separately from goodwill." Such treatment will certainly not be deemed appropriate in the future.

2. What is the process for creating a sound, defensible purchased price allocation?

The process for determining the appropriate purchase price allocation differs for each transaction. However, on the basis of the allocations we have performed over the past year, the following outline can serve as a general guide:

- \* Determination of the Purchase Price – This often-overlooked step is not so simple when a portion of the consideration consists of assets other than cash.

- \* Identification of Intangible Assets Acquired – FAS 141 provides extensive guidance to aid in determining whether a specific intangible asset needs to be recognized in the financial statements. In general, an intangible asset must be recognized if it arises from contractual or legal rights, or if it is separate from the acquired entity.

- \* Valuation of Tangible Assets Acquired – Before determining the value to assign to the intangible assets acquired (including goodwill), the appropriate valuation of the acquired tangible assets must be considered. In other words, do the tangible assets require a discount or premium to their state book values? For acquisitions with a large component of fixed assets, the services of a real estate or machinery and equipment appraiser may be helpful.

- \* Valuation of the Recognized Intangible Assets – While specific techniques may vary, the valuation of intangible assets relies upon the same basic approaches (cost, market, and income) as the valuation of business interests. Valuations should include thorough support for each major assumption.

- \* Reconciliation to Purchase Price – When all required intangible asset valuations have been performed,

the conclusions should be compared and reconciled to the price paid for the acquired entity. On a relative basis, are the amounts assigned to the various assets consistent the purpose of and rationale for the acquisition? What does the amount of goodwill imply regarding the motivations of the buyer and seller, the prevailing market and industry conditions, and the nature of the business acquired?

### 3. What is the deadline for completing the purchase price allocation?

FAS 141 is not explicit with regard to how promptly the purchase price allocation must be completed after an acquisition. The Standard defines the allocation period as “the period that is required to identify and measure the fair value of the assets acquired and the liabilities assumed in a business combination. The allocation period ends when the acquiring entity is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable.” The Standard further states that “although the time required will vary with circumstances, the allocation period should usually not exceed one year from the consummation of a business combination.”

### 4. Can we perform the purchase price allocation internally?

There is no specific proscription in the Standard against performing the purchase price allocation internally. However, FAS 141 does state (at paragraph 36) that, “Among other sources of relevant information, independent appraisals and actuarial or other valuations may be used as an aid in determining the estimated fair values of assets acquired and liabilities assumed.” In other words, retention of a valuation expert is not required, but your auditor will likely be eager to hear the explanation of why an independent expert was not retained to assist in the allocation.

The best independent expert to assist in the allocation process will have experience in business valuation, intangible asset valuation, and transaction advisory work. The expert should be thoroughly acquainted with the provisions of FAS 141 and 142 and have experience performing both purchase price allocations and goodwill impairment testing. We will partner with your finance staff in completing an appropriate, defensible purchase price allocation.

#### VMI Highlights

Value Management Inc. (“VMI”) proudly sponsored the November 19, 2002 Philadelphia Estate Planning Council’s (“PEPC”) luncheon held at the Union League in Philadelphia. Approximately 275 PEPC members were on hand for David W. Reinecke’s presentation on “The Use of Family Limited Partnerships in Planning for Life Insurance.” It was an excellent presentation that drew acclaim from attendees. Feel free to call our office for a copy of Mr. Reinecke’s handout (ask for Kathy).

At the PEPC’s November 19, 2002 luncheon, Andrew Wilusz, ASA was honored with the PEPC’s Committee Member Achievement Award in recognition of outstanding volunteerism for his work on the membership, program and long range planning committees. Congratulations, Andrew!

Ed Wilusz, ASA, CFA spoke at a November program sponsored by the PA/DE Chapter of the ESOP Association entitled ESOP Issues in an Uncertain Economy. Ed’s topic was “Valuation Issues when your Market is Faltering.”

Ed Wilusz, ASA, CFA also spoke to the Chester County Bar Association on the topic of “What Every Attorney Should Know about Business Valuations.” Additionally, he spoke to the Centre County Bar Association on the topic of business valuations.

#### Acquisition Opportunities

\* Plastics related business located in the Tri-State area, with sales of \$6 to \$7 million, the total return to owner is in the \$1 million range.

\* Well-established mechanical contracting business located in PA (plumbing and HVAC services primarily to builders for new and renovation residential construction). With revenue of \$5.5 to \$6.5 million, pre-tax income has averaged \$0.3 million over the last five years.

Please call Andrew Wilusz, ASA, Director of Mergers & Acquisitions at 215-598-9310 if you or your clients

have an interest in the above companies.

Value Management Inc.  
758 Durham Road  
Newtown, PA 18940

Telephone: (215) 598-9310  
Fax: (215) 598-0589  
E-mail: [info@valuemanagementinc.com](mailto:info@valuemanagementinc.com)