ACUITY VALUATION

ASC 805 Introduction to the Valuation of Intangible Assets in Business Combinations

Overview

- ASC 805 applies to business combinations (used to be SFAS 141 (R))

Overview

- Applies when an enterprise buys:
  - Net assets that constitute a business; OR
  - Controlling equity interest of another enterprise

Overview

- Step 1 – Identify all assets of the acquired entity
  - Tangible AND
  - Intangible
- Step 2 – Assign value to assets acquired
- Step 3 - Excess of price paid over the assigned values = Goodwill

Value = FAIR VALUE

- Applicable value to use is “Fair Value”
- Applies to all assets, tangible and intangible
- ASC 820 defines Fair Value (SFAS 157):
- “the price that would be received to sell an asset….in an orderly transaction between market participants at the measurement date”

Highest and Best Use

- Assumes “highest and best use of asset”
- So if in an acquisition, a company buys a competing product and trade name and will phase it out, the trade name should still be valued and placed on balance sheet

Fair Value – Key Points

- Fair value is an “exit price” i.e. what the asset could be sold for
  - What was just paid for it may or may not be relevant

Market Participant

- The price is what a “market participant” might pay
- Buyers and sellers in the principal market that are:
  - Independent of the reporting entity
  - Knowledgeable of the asset or liability and the transaction
  - Able to transact for the asset or liability
  - Willing and motivated to transact for the asset or liability

Not Fair Market Value

- Not the same as “fair market value” where the standard talks about a hypothetical willing buyer
- Synergistic values may come into play under fair value standard
- Consider both strategic and financial buyers
  - Often strategic market participant will produce max value

What is an Intangible Asset

- Must be either:
- Based on contractual or legal rights
- OR
- Capable of being separated and sold or licensed or rented
- Note – many of these assets are not on the balance sheet

Marketing Related Intangibles

- Trademarks, service marks
- Tradenames
- Internet domain names
- Non-compete agreements

Customer-Related Intangibles

- Customer lists
- Order backlogs
- Customer contracts
- Non-contractual customer relationships

Artistic-Related Intangibles

- Copyrights in:
  - Plays
  - Books
  - Music
  - Pictures/Photos
  - Video

Contract-Based Intangibles

- Royalty agreements
- Franchise agreements
- Employment contracts
- Favorable lease agreements
- FCC Licenses etc.

Technology-Related Intangibles

- Patents
- Computer software
- Databases
- Trade Secrets

Valuation Methods - Cost

- Cost to Reproduce
  - Labor/material/overhead
  - Take into account obsolescence
- Applied to:
  - Computer software
  - Possibly customer relationships

Relief From Royalty

- Applied to patents/trademarks/trade secrets
- Value is equal to the present value of the royalty expense that is avoided through ownership of the asset
- If the market indicates that owners of similar technology gets 3% of sales as a royalty
  - Project out sales
  - Multiply by 3% in each year to determine the notional royalty that would have been paid
  - DCF to determine present value

With and Without Analysis

- Often applied to non-compete agreements
- Determine value of acquired business based on projections assuming
  - A. Non-compete is in place
  - B. Non-compete is not in place
- Subtract one value from the other
- Apply a probability of competition to get a final value

With and Without Analysis

Value of Business without competition	5,000
Value of Business with competition	3,000
Initial Value of Non-compete	2,000
Likliehood of Competition	30%
Final Value of Non-compete	600

Valuation Methods - Income

- Multi-Period Excess Earnings - Applied to primary cash generating asset e.g. customer relationships; technology
  - Determine the future cash flows of business acquired
  - Assume all other assets need to be “rented” from an owner i.e. incur a charge to compensate for use based on market rates of return
  - Subtract these charges from projected cash flow – resulting cash flow relates to primary asset and use DCF to value

Multi Period Excess Earnings

Year			1	2	3	4	5
Net Cash Flow			500	600	700	800	900
Less Returns on	Value	Rate of Return					
Net Working Capital	500	3%	15	15	15	15	15
Fixed Assets	1000	6%	60	60	60	60	60
Trade Name	600	15%	90	90	90	90	90
Non-Compete	100	15%	15	15	15	15	15
Patent	300	18%	54	54	54		
Surviving Net Cash Flow			266	366	466	620	720
Discount Rate	15%						
NPV	1,527						

Projections

- Financial projections are essential in this process
- Valuation methods rely on using management's projections
- May want to consider this in the acquisition negotiations

Assembled Workforce

- Is an intangible asset but included with goodwill on financial statements
- However – need to value to use MPEE method – treated as a separate asset with an associated rate of return
- Cost to replace methodology

Why Does This Matter?

- Different types of intangibles have different useful lives
- Patents may only be valid for a limited number of years
- Non-compete agreements may only last for a specified period
- Technology life requires complex analysis
- Tradenames, trademarks may have indefinite lives
- Goodwill also indefinite life - only impairment – though private company now allowed to amortize over 10 years
- Net Income affected by intangible amortization expense

Alternative Accounting

- Private company can elect accounting alternative
- No longer recognize the following separate from goodwill:
  - Customer-related intangible assets unless capable of being sold or licensed independently (Note – key customer related intangibles can be sold separately e.g. contact information).
  - Noncompetition agreements

Allocation for Tax

- IRS also requires allocation of value to acquired assets for tax purposes
- Form 8594 breaks down assets into 6 classes
- For these purposes “section 197” intangibles and goodwill are treated identically – 15 year depreciation
- Section 197 intangibles similar to list above
- This will cause differences between book and tax depreciation