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

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<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Value of Business without competition</td>
<td>5,000</td>
</tr>
<tr>
<td>Value of Business with competition</td>
<td>3,000</td>
</tr>
<tr>
<td>Initial Value of Non-compete</td>
<td>2,000</td>
</tr>
<tr>
<td>Likelihood of Competition</td>
<td>30%</td>
</tr>
<tr>
<td>Final Value of Non-compete</td>
<td>600</td>
</tr>
</tbody>
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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

<table>
<thead>
<tr>
<th></th>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
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</thead>
<tbody>
<tr>
<td><strong>Net Cash Flow</strong></td>
<td></td>
<td>500</td>
<td>600</td>
<td>700</td>
<td>800</td>
<td>900</td>
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<tr>
<td><strong>Less Returns on</strong></td>
<td><strong>Value</strong></td>
<td></td>
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<tr>
<td><strong>Net Working Capital</strong></td>
<td></td>
<td>500</td>
<td>3%</td>
<td>15</td>
<td>15</td>
<td>15</td>
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<tr>
<td><strong>Fixed Assets</strong></td>
<td></td>
<td>1000</td>
<td>6%</td>
<td>60</td>
<td>60</td>
<td>60</td>
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<tr>
<td><strong>Trade Name</strong></td>
<td></td>
<td>600</td>
<td>15%</td>
<td>90</td>
<td>90</td>
<td>90</td>
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<tr>
<td><strong>Non-Compete</strong></td>
<td></td>
<td>100</td>
<td>15%</td>
<td>15</td>
<td>15</td>
<td>15</td>
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<tr>
<td><strong>Patent</strong></td>
<td></td>
<td>300</td>
<td>18%</td>
<td>54</td>
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<tr>
<td><strong>Surviving Net Cash Flow</strong></td>
<td></td>
<td>266</td>
<td>366</td>
<td>466</td>
<td>620</td>
<td>720</td>
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<tr>
<td><strong>Discount Rate</strong></td>
<td></td>
<td></td>
<td>15%</td>
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<tr>
<td><strong>NPV</strong></td>
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<td>1,527</td>
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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 MP EE 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