Valuing Intangibles in a Business Combination

What Are Intangible Assets?

The International Valuation Standards Committee defines intangible assets as "...assets that manifest themselves by their economic properties; they do not have physical substance, they grant rights and privileges to their owner; and usually generate income for their owner. Intangible Assets can be categorized as arising from Rights, Relationships, Grouped Intangibles, or Intellectual Property.[i]

Probably the briefest definition was provided by the FASB:

…assets (not including financial assets) that lack physical substance.[ii]

Per the FASB, intangible assets are distinguished from goodwill. The FASB provides specific guidance for the identification of intangible assets such that any asset not so identified would fall into the catch-all category of goodwill.

The Nature of Intangible Assets

Intangible assets are a subset of human capital, which is a collection of education, experience, and skill of a company's employees. Further, intangible assets receiving legal protection become intellectual property, which is generally categorized into five types: patents, copyrights, trade-names (-marks and –dress), trade secrets, and know-how.

Identification and Classification

Identification of intangible assets is as broad as the business mind is creative. There are the well-accepted intangibles such as the customer base, in-process research and development, and technology, as well as intellectual property (see the five types above). The value of these assets typically account for a vast majority of an enterprise's total intangible value, depending on the industry. There are also unique intangible assets peculiar to an industry or enterprise such as deposits in a bank.

In an attempt to provide some structure to the recognition of identifiable intangible assets, the FASB has classified intangibles into five categories:

- Marketing-related intangible assets (i.e., trademarks, trade names)
- Customer-related intangible assets (i.e., customer lists, customer relationships)
- Artistic-related intangible assets (i.e., pictures, photographs)
- Contract-based intangible assets (i.e., licensing agreements, supply contracts), and

- Technology-related intangible assets (i.e., technology with and without patents).[iii]

Assembled workforce is excluded because it fails the separability and transferability test. A company may have the best employees of the highest value in the world, but they have no value if separated from the business. Thus, the FASB chose to categorize assembled workforce within the components of goodwill.

Fair Value and Business Combinations

The definition of fair value as stated in SFAS No. 141 is:

The amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.[iv]

In contrast, fair *market* value is defined in the Internal Revenue Code as:

The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.[v]

A principal difference between the two definitions is that the fair value for the business enterprise considers synergies and attributes of the specific buyer and specific seller (i.e., the purchase price of the business combination), while fair market value contemplates a hypothetical willing buyer and a hypothetical willing seller.

A business combination occurs when an enterprise acquires the net assets that constitute a business or equity interest of one or more enterprises and obtains control over that enterprise or enterprises.[vi]

Overview of FAS 141

In accordance with the provisions of Financial Accounting Standards ("FAS") No. 141, all identifiable assets acquired, including identifiable intangible assets, are assigned a portion of the cost of the acquired enterprise (the "purchase price") on the basis of their fair values.

- Intangible assets, both identifiable and unidentifiable, may be acquired in a business combination or developed internally. Intangible assets that are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole are classified as *goodwill*. Purchased goodwill arising on the acquisition of one business by another is defined as the excess of the purchase price of the acquired business over the fair value of its net tangible and identifiable assets.

- According to FAS No. 141, an acquiring corporation should allocate the cost of an acquired company to the assets acquired and liabilities assumed, using the following principles:
  - All identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company, should be assigned a portion of the cost of the acquired company, normally equal to the fair values at the date of acquisition;
  - The excess cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill.
- Identifiable assets that can reliably be measured should be separately recorded in the financial statements of the acquirer at their fair value. Each intangible asset is not necessarily reliably measurable; this determination should be based on individual facts and circumstances. Those intangible assets that are identifiable but not reliably measurable are considered to be elements of goodwill.

Under what circumstances are assets separately recognized?

Under FAS No. 141, an acquired asset should be separately recognized if the benefits:

(1) Arise from contractual or other legal rights, regardless of whether those rights are transferable, and, if they are transferable, regardless of whether the acquirer intends to transfer them, or;

(2) Are separable. This means that the asset can be transferred, licensed, or rented individually or in combination with a related contract, asset, or liability, regardless of whether the acquirer intends to transfer, license, or rent it.

Summary

When valuing intangible assets in a business combination, all of the previously mentioned categories of intangible assets must be considered. This means the appraiser needs to determine the separability of the intangible assets and include detailed discussions related to the marketing-, customer-, artistic-, contract-, and technology-based intangibles assets.

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[i] International Valuation Standards, Guidance Note No. 4, *Intangible Assets* (2001), at 3.15.

[ii] Financial Accounting Standards Board, Statement of Financial Standards No. 141: *Business Combinations* (June 2001), p. 124.

[iii] Financial Accounting Standards Board, Statement of Financial Accounting Standards, No. 141: *Business Combinations* (June 2001), at 14.

[iv] Financial Accounting Standards Board, Statement of Financial Accounting Standards, No. 141: *Business Combinations* (June 2001), Appendix F.

[v] Internal Revenue Service, Revenue Ruling 59-60, §2.02.

[vi] Financial Accounting Standards Board, Statement of Financial Accounting Standards, No. 141: *Business Combinations* (June 2001), at 9.