Fair Value and Financial Reporting
Valuations: Measuring the Intangibles
Sean Saari, CPA/ABV, CVA, MBA

- Getting Everyone on the Same Page in Purchase Price Allocations
- Intangible Asset Valuation: If I Cannot See Them, What Are They?
- Management Involvement in the Purchase Price Allocation Process
- Indefinite-Lived Intangible Asset Impairment Testing
**Introduction**

“That quarterback has all the intangibles.” This is a pretty common phrase that is thrown around by sports reporters during the weeks and months leading up to the NFL draft. These “intangibles” are things that cannot be quantified or measured, such as heart, leadership ability, focus, drive and the list goes on. However, they can be just as, if not more important, than tangible metrics like height, weight and 40 yard dash time when it comes to success on the field. Just like with professional athletes, businesses have intangible assets that make them valuable: customer relationships, technology, non-competition agreements, trademarks, licenses and so on. Unlike the quarterback’s intangibles, which are not measureable, Generally Accepted Accounting Principles (GAAP) require that a company’s intangible assets be valued and recorded in the event it is purchased by another company in a business combination. Knowing how intangible assets are valued and how to account for them can go a long way in making sure that the accounting for a new acquisition goes smoothly and will pass your auditor’s review.

This e-book will help you better understand the following:

- Purchase Price Allocations
- Intangible Asset Valuation
- Management Involvement in the Purchase Price Allocation Process
- Indefinite-Lived Intangible Asset Impairment Testing

If you are interested in learning more about fair value and financial reporting valuations, I invite you to continue reading this e-book.

**About the Author**

Sean Saari, CPA/ABV, CVA, MBA - Skoda Minotti

Sean is a senior manager with Skoda Minotti’s Business Valuation and Litigation Support Group. In this role, he is responsible for the development review and issuance of valuation reports, calculation of value reports, and expert reports under valuation and consulting standards. Sean has assisted a diverse client base in litigated matters, domestic disputes, shareholder disputes, estate and gift tax filings, and financial reporting valuation issues.

Additionally, Sean serves in Skoda Minotti’s Accounting & Auditing department. He is primarily responsible for performing audits, reviews and compilations for companies in a variety of industries.

Sean earned his Masters of Business Administration (with honors) from Case Western Reserve University and his Bachelors of Business Administration (with honors) from the University of Notre Dame. He is a member of the American Institute and Ohio Society of Certified Public Accountants, the National Association of Certified Valuators and Analysts, and the Center for Principled Family Advocacy. Sean is the recipient of the 2010 Jeffrey R. Salins Report Writing Award, and serves as Chair of the Marketing Committee on the Lake Catholic High School Advisory Board. He is also a member of the AICPA’s ABV Exam Review Task Force and NACVA’s Case Study Peer Review Team and Q&A Review Team.
Getting Everyone on the Same Page in Purchase Price Allocations

“Practice? We’re talking about practice?” I doubt that Allen Iverson knew that his words would live in infamy when he discussed practice in an interview a number of years ago. I think that many of us would disagree with the lack of importance he associated with practice – practice is the time that the head coach, his or her assistants, and the team discuss and implement strategies for their next game. It is a time that can be used to regroup and make sure that everyone is on the “same page” moving forward. When working through a purchase price allocation and the related accounting for an acquisition, it can be just as important to get all of the parties involved on the same page before moving forward.

When a company makes an acquisition, it is often necessary to prepare a “purchase price allocation” in which the purchase price for the target company must be allocated to all of the assets acquired (both tangible and intangible). The valuation of the intangible assets acquired is a relatively complex process for which a third-party valuation expert is often engaged. We have found that getting the company, the auditor and the valuation expert on the same page before the intangible asset valuation analysis is started offers the best opportunity for a smooth process with few surprises.

We recommend scheduling a meeting or conference call in which company representatives, the auditor and the valuation expert can discuss the acquisition together and define parameters for the following:

**Intangible Assets to be Valued** – Discuss and define what intangible assets need to be valued and the valuation methodologies to be used. This helps to eliminate potential surprises later in the process. No one wants to be in a position in which the auditor reviews the valuation report and finds that it does not include a certain intangible asset that he or she believes should have been valued.

**Materiality / Scope** – Determine how significant the acquisition is to the acquirer’s existing business. Based on the size of the purchase and its materiality in relation to the company’s overall operations, it may be possible to scale back the valuation procedures performed while still providing the auditor with sufficient audit documentation.

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Getting Everyone on the Same Page in Purchase Price Allocations (cont.)

**Timing** – Determine the date by which a draft of the valuation report needs to be completed in order to give sufficient time for company management to review the analysis and for the auditors to perform their audit procedures and ask follow-up questions. Most acquisitions are closed throughout the year, not necessarily on December 31, so get the valuation process started early to avoid the need to rush the process as well as provide cushion for potential roadblocks.

Valuation experts are becoming more and more involved in working with auditors and their clients to issue fair value opinions for financial reporting purposes. The International Valuation Standards Council recently released and exposure draft on this very topic. As discussed above, starting out the purchase price allocation process by getting all of the parties involved on the same page can go a long way in ensuring a smooth process with few surprises.
Intangible Asset Valuation: If I Cannot See Them, What Are They?

“All arguments concerning existence are founded on the relation of cause and effect.” - David Hume

In the quote above, David Hume, a famous philosopher, says that the basis of existence is founded in cause and effect. Cause and effect is simple to picture for tangible objects – if I cause my finger to type a letter on the keyboard, that letter shows up on my computer screen. It becomes a little more difficult to picture cause and effect with intangible things – if I greet a stranger on the sidewalk as I walk past them, did that greeting have a positive or negative effect on them?

Similar to the example above, it is often much more difficult to determine the value of intangible assets in the acquisition of a company compared to determining the value of the company’s tangible assets. Intangible assets are just that – non-tangible, non-physical. This can make identifying and valuing such assets a difficult task, although it must be done to comply with Generally Accepted Accounting Principles related to business combinations and purchase accounting.

Let us begin with tangible assets, for which the cause and effect that identify their existence are easily perceived:

**Cash** – Cash is a tangible item, regardless of whether it is in the form of greenbacks or in a bank account. There are many causes for spending cash, the effect of which is often the receipt of goods or services.

**Fixed Assets** – By causing the fixed assets to operate, salable product is produced by manufacturing companies.

**Accounts Payable** – By causing the purchase of an item without making payment at the time the item is received, the effect is the creation of an accounts payable liability.

Things get a little more complicated when dealing with intangible assets. In an effort to help you identify intangible assets that may have been part of an acquisition, the list below presents the intangible assets most often recorded in business combinations:

**Customer Relationships** – Most companies have repeat customers that continue to return time and time again for goods or services. To the extent that these customers can be identified, the customer relationships have intangible value since the purchaser can expect the customers to continue to do business with the acquired company after the deal has closed.

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**Trademarks** – Trademarks included registered trademarks, trade names and related items that identify a company. The existence of a well-known trademark may cause a person to purchase a particular item, the effect of which is cash flow to the company providing the good or service.

**Noncompetition Agreements** – A noncompetition agreement causes a key employee to refrain from competing against the newly purchased company, the effect of which is that the revenue and margins of the company are protected from the dilution that could have resulted from the competition of that key person.

**Technology** – While technology often results in the creation of tangible products, the general “know-how” behind a company’s technology is another commonly recorded intangible asset. Such technological know-how is the cause that allows a company to offer products or services which, as a related effect, meets needs that customers are willing to pay for.

There are numerous other types of intangible assets that exist and are recorded as a result of purchase accounting depending on the facts and characteristics of the acquired company. The list above should provide you with an idea of the “unseen” or intangible assets that are most often recorded in business combinations.
Management Involvement in the Purchase Price Allocation Process

It is common for companies to bring in a third-party valuation expert to value the intangible assets acquired in a business combination for financial reporting purposes. It is important to note that even when a third-party valuation analyst is involved, a considerable amount of time will need to be devoted by management in order to complete the valuation analysis.

The valuation of intangible assets is not a “hands-off” process for a company’s management. Actually, purchase price allocation valuation engagements often require the most involvement of company management of any type of valuation. Why? The valuation of intangible assets requires the development of a number of assumptions and estimates about the company’s future operating activity. The valuation analyst cannot make these items up as he or she goes along – instead, it requires a significant commitment by management to assist the valuation expert with developing appropriate estimates that will pass auditor scrutiny.

If such a high level of management involvement is required for intangible asset valuations, you may ask, “Why should I hire a third-party valuation analyst at all?” The benefits of using a valuation analyst to assist with the purchase price allocation are that he or she can do the following:

- Ask the right questions to draw out the necessary information to properly complete the analysis
- Develop financially and technically sound valuation models
- Address inconsistencies in management estimates (in comparison to prior operating activity) before your auditor makes an issue of them
- Prepare a sound report that will answer many of the questions that your auditors will have regarding the determination of the intangible assets’ values
- Provide you with someone who will stand up for his or her analysis and work with the auditors to resolve any issues, saving you time and frustration from having to handle this yourself

Remember, if you are in need of a purchase price allocation/valuation of intangible assets, bringing in a third-party expert to perform the valuation does not mean that you are “off the hook” at that point. The valuation process often turns into a collaborative matter in which both the analyst and management work together to create a supportable analysis.

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Indefinite-Lived Intangible Asset Impairment Testing

For companies out there with indefinite-lived intangible assets on their books, your annual impairment testing just got much simpler. On the heels of FASB permitting “qualitative” goodwill impairment analyses instead of requiring quantitative computations (see our previous blog, What Do the Proposed Changes to Goodwill Impairment Testing Mean For You), a similar change has been made for indefinite-lived intangible assets such as trademarks and licenses.

Rather than requiring an annual computation to determine whether the fair value of an indefinite-lived intangible asset is impaired, FASB is now providing companies the option to first assess certain qualitative factors to determine whether it is a more likely than not (greater than 50% chance) that the fair value of an indefinite-lived intangible is less than its carrying value. The qualitative factors typically considered include the financial performance of the company, industry and economic changes, cost factors, legal and regulatory matters, and other company-specific issues. If no impairment is indicated by this qualitative analysis, no further quantitative testing is necessary. This change is effective for annual and interim impairment tests performed for fiscal years beginning after Sept. 15, 2012, but early adoption is also permitted.

For finite-lived intangible assets such as customer relationships, covenants not to compete and technology, the old impairment testing rules still apply (see our previous blog, What We Can Learn About Intangible Asset Impairment from LeBron’s Free-Agency). These rules require a company to compare the undiscounted future cash flows associated with a finite-lived intangible asset to the asset’s net carrying value on the balance sheet. If the future undiscounted cash flows are greater than the net carrying value of the asset (which is most often the case), then there is no impairment. If the future undiscounted cash flows are less than the net carrying value of the asset, however, then impairment exists and those future cash flows are discounted back to the testing date to determine the new fair value of the asset. Because finite-lived intangible assets are amortized, they decrease in value on a company’s balance sheet each year. Therefore, the standards allow companies to consider the undiscounted future cash flows associated with these intangibles in testing whether they are impaired, which makes it much more difficult to fail than if the actual fair values of the intangibles were determined (using discounted cash flows).

Remember, before implementing changes to your impairment testing procedures, discuss the changes with your auditors to ensure a smooth transition.

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