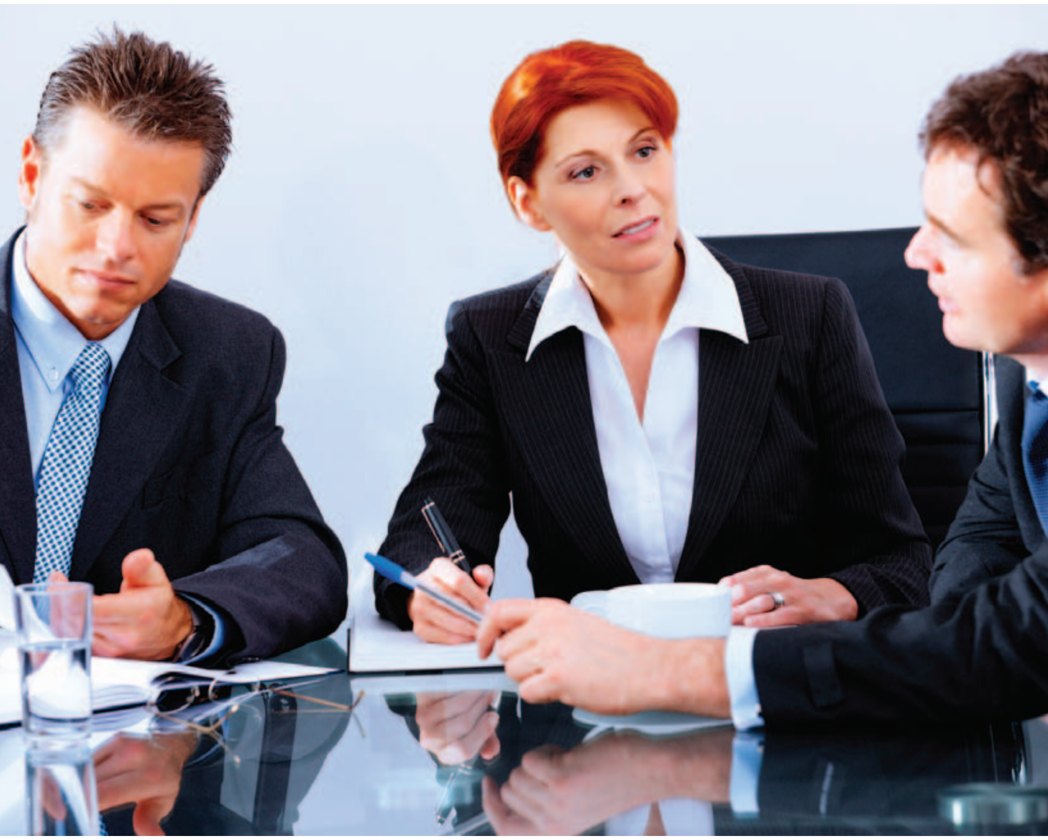
Viewpoint on Value



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Purchase price allocations: Acquiring minds want to know

When planning to merge with or acquire another company, a business owner needs to identify what's actually being sold and estimate what those assets are really worth. Often the most valuable assets — such as goodwill, brand names, customer lists and patents — don't appear on the balance sheet.

A preacquisition purchase price allocation helps an owner determine whether a purchase price is reasonable. In addition, how the purchase price is divvied up on the acquirer's balance sheet has an impact on future earnings — thus affecting the transaction's perceived success.

Identify the assets

Under Generally Accepted Accounting Principles (GAAP), companies that merge with or acquire another must allocate the purchase price among the assets and liabilities acquired according to Accounting Standards Codification (ASC) 805 (formerly covered by Statement of Financial Accounting Standards No. 141R).

The first step in any purchase price allocation is to identify all tangible and intangible assets included in the deal. Examples of tangible assets are accounts receivable, equipment and inventory.

To help categorize identifiable intangible assets, ASC 805 provides a framework based on whether the asset is related to:

- Marketing (trademarks, noncompete agreements, Internet domain names),
- Customers (customer lists, production backlogs),
- Artistic practice (copyrighted books, articles, photographs),
- Contracts (royalty agreements, franchises, leases, employment contracts), or
- Technology (patents, trade secrets, in-process research and development, computer software).

The acquirer must estimate a useful life over which to amortize each intangible asset. But some intangible assets, such as brand names and in-process research and development, may have indefinite economic lives. These are tested at least annually for impairment. (See "Inaccurate allocations strike back" on page 3.)

Estimate the cash-equivalent purchase price

The next step is to evaluate the total consideration to be paid for the company. Purchase price is obvious in many transactions. But the waters are muddier when

Inaccurate allocations strike back

Valuing intangible assets is not a one-time exercise. Accounting Standards Codification (ASC) 350 (formerly covered by Statement of Financial Accounting Standards No. 142) requires companies to test goodwill and other indefinite-lived intangible assets at least annually for impairment.

Impairment testing is a two-step process. First, the company (or reporting unit if there are multiple divisions or product lines) is valued. If the book value of the reporting unit is more than its fair value, impairment has occurred.

Next, fair value is allocated among the reporting unit's assets and liabilities. This exercise is similar to a purchase price allocation under ASC 805 (see main article). The unallocated portion of the fair value is attributed to goodwill. The difference between the fair value of an intangible asset and its book value is written off as an impairment loss.

Sloppy, do-it-yourself purchase price allocations may result in future impairment losses, which, in turn, raise a red flag to lenders and investors. An experienced valuation professional can help get intangible asset valuations right the first time around.

private stock is exchanged, an entrepreneur signs a noncompete or employment agreement, contingent liabilities exist, or part of the selling price is contingent on future earnings.

A valuator can help convert these payment terms into a current cash-equivalent price and separate out personal payments to shareholders from the amount paid for business assets — a prerequisite to accurate purchase price allocations.

Value the assets

Now comes the heart of the purchase price allocation: valuing the assets. Book value may be a reasonable proxy for many tangible assets, including marketable securities, receivables and inventory. A real estate or machinery appraiser can help with fixed assets.

Intangible assets, while increasingly important in today's knowledge-based economy, are more complex and difficult to appraise. ASC 805 recommends using the market approach to estimate the fair value of intangible assets, because it relies on actual market transactions. But in practice, the market approach may be difficult to apply due to the special nature of intangible assets as well as the lack of comparable transaction details.

Instead, valuators often opt for the cost approach or the income approach. Under the cost approach, fair value equals the cost to reproduce or replace the asset. This approach is most relevant for internally generated intangibles, such as software or secret formulas.

More common is the income approach, which bases value on an asset's future economic benefits. For example, the relief-from-royalty method derives value from the cost savings of not having to pay a royalty for use of the intangible asset. Alternatively, valuators sometimes perform discounted cash flow analyses, in which an asset's cash flows are projected and then discounted to their net present value.

Intangible assets, while increasingly important in today's knowledge-based economy, are more complex and difficult to appraise.

When using the income approach, the valuator typically avoids double-counting one income stream for two (or more) separate intangible assets. Additionally, he or she ensures that discount rates are commensurate with the risks of the intangible asset, not necessarily the acquirer's overall discount rate.

Assign the remainder to goodwill

After the appraiser has allocated value among identifiable assets and liabilities, the remainder is categorized as goodwill. Goodwill has an indefinite useful life. Therefore, it is no longer amortized under ASC 805.

The recession has forced some businesses to sell at bargain prices. In these cases, the combined amount allocated to the acquired assets may exceed the purchase price. Rather than record negative goodwill, the acquirer records a one-time gain at the time of sale under ASC 805.

Pay attention upfront

Too often an afterthought, purchase price allocations should be premeditated. Before embarking on a merger or acquisition, business owners and their legal advisors should work with a valuation professional to ensure the transaction makes sense from a financial reporting perspective and to eliminate unpleasant postdeal surprises. ●

Projected cash flow

History doesn't tell the whole story

A rational investor would never buy an asset without a reasonable expected return. An investment's value is based on what economic benefits — whether in the form of dividends, interest or cash flow — it's expected to generate in the future. Projected cash flow is thus an important measure of future economic benefits.

And a business's historic cash flows may not be an accurate measure of its expected future performance. Some businesses — such as a mature, stable company that manufactures a product undifferentiated from its competitors with an easily foreseeable demand and a known market size — may grow at a relatively constant rate. But, especially in an uncertain business climate, most companies experience significant changes each year as they progress through product life cycles, adapt to changing technology and move into new markets. As a result, they don't grow at constant rates. That's why a cash flow projection can be valuable.

2 methods

When projecting cash flow, a valuator generally uses the income approach, which involves one of the following methods, depending on the circumstances:

1. Capitalization of income method. If a company's historic cash flows are likely to continue, and its growth rate appears relatively stable, a valuator might use the capitalization of income method. This method is more appropriate when the economic benefits (net income and cash flows) are fairly constant and are expected to continue to be so in the future. It employs an expected constant risk (capitalization) factor.

2. The discounted cash flow or earnings method. If a valuator can't use historic cash flows as a proxy for predicting future performance, or can't expect the growth rate to remain relatively constant over time (literally, into perpetuity), a discounting method will more accurately determine the business's value. The discounted cash flow or earnings method

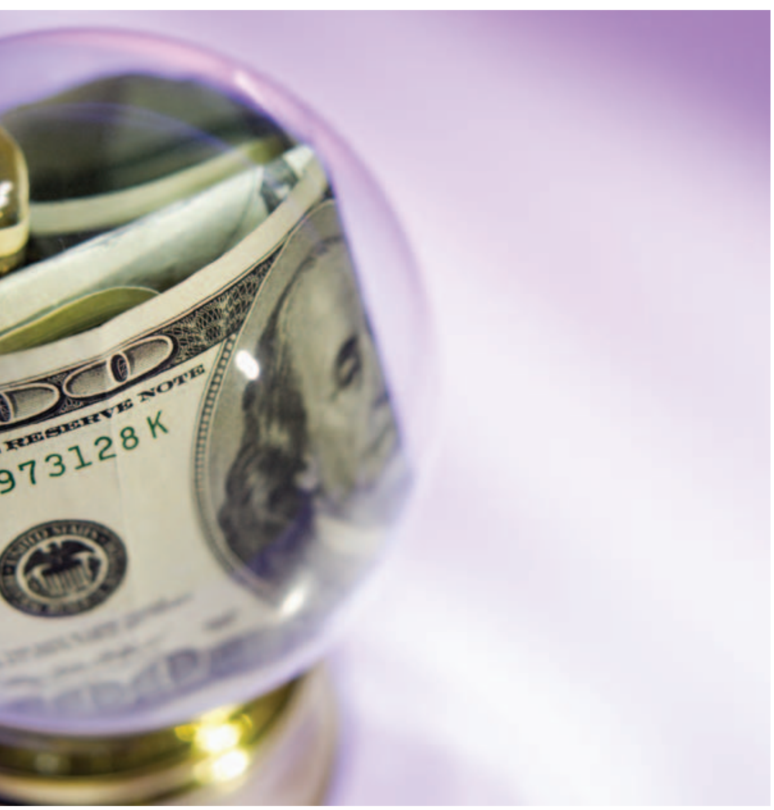
recognizes that a dollar today is worth more than one received in the future, and discounts a company's projected earnings to adjust for real growth, inflation and risk.

Variables a valuator considers include whether the base period financial position (usually the current year) is a representative year, whether the company's future performance is expected to be a continuation of established trends, and whether the projection period should be three, five or 10 years. (For a cyclical business, the forecast must incorporate a full cycle.)

In addition, the discount rate, along with the timing of future cash flow, provides the present value of cash flows or earnings over the life of the business and has a large effect on the valuation. Careful analysis of the appropriate discount rate is essential.

Profit vs. cash

Experienced business owners know that profits mean nothing if there isn't enough cash left over to pay their salaries and dividends. A common question from frustrated business owners is: Why does my profitable business frequently seem on the brink of a cash crisis? Although normally desirable, growth is often the culprit.



For instance, the cash operating cycle is the amount of time it takes a business to convert raw materials into cash collections. The clock starts ticking as soon as inventory is purchased, continues running during the manufacturing and billing processes, and stops when the customer pays the invoice. Unfortunately, most businesses receive payment from customers long after they've paid for key operating costs, including salaries, rent and supplies. The lag between cash expenditures and cash receipts can cause a cash shortage, if not properly planned for. Higher growth rates and longer cash operating cycles compound cash shortfalls.

Valuation experts have more in their bag of tricks than the ability to appraise a business interest.

Cash flow projections can help owners manage cash flow more efficiently and survive the monthly (or off-season) cash crunch. Unlike accountants — who tend to communicate in terms of balance sheets and income statements — valuators appreciate the role that cash flow plays in driving shareholder value. They can help explain complex business concepts in terms of their effects on cash.

Beyond the purpose of a valuation, a valuator's cash flow projection can serve as a useful planning tool, helping management prepare cash flow budgets, evaluate strategic investment decisions, devise reorganization strategies, and brainstorm profit and efficiency enhancement alternatives.

Valuation bag of tricks

Valuation experts have more in their bag of tricks than the ability to appraise a business interest. As part of their professional training, valuators learn how to project cash flows and to calculate the present value of those cash flows using an appropriate discount rate. This expertise makes them uniquely suited to help management increase efficiency and profitability. ●

Settling shareholder disputes

Valuators build a bridge over troubled waters

A company's owners tend to get along when times are good, but economic downturns can bring out the worst in shareholder relations. For instance, minority shareholders might suspect controlling shareholders of withholding dividends or financial information. Siblings might disagree about the appropriate strategy for their family business. Or a creative partner might violate his noncompete agreement by diverting intellectual property to another business in which he's the sole owner.

Valuators can help settle shareholder disputes — both in and out of court — allowing the remaining owners to refocus their attention on building and preserving value.

Case in point

Let's look at a fictional scenario representative of many real-life ones that have been playing out over the last couple of years: When Felix and Oscar went into business in 2000, they thought it was a perfect marriage. Felix, who was disciplined and organized, handled finance, production and human resources chores. Creative and charismatic Oscar focused on product development, marketing and sales. Everything ran smoothly until the recession caused the company to miss its sales and profit goals.

Oscar decided Felix's conservative ways were hampering growth. Felix accused Oscar of lavish R&D and entertainment spending. Their constant bickering caused several key managers to resign. Both partners wanted to dissolve the company but couldn't agree on buyout terms.

Their attorney recommended hiring a valuation professional to sort out the details. The first step was an appraisal. The valuator analyzed future cash flows and provided several real-life comparable transactions to support her estimate. Then she provided recommendations regarding the timing and structure of a potential buyout to maximize cash flow, minimize taxes and comply with the shareholder agreement.

Felix and Oscar were surprised to discover that, in the current economy, their business wasn't worth much more than book value. After objectively evaluating the facts, the frustrated owners decided it made more sense financially to stay "married." Leveraging the valuator's industry know-how and her financial analyses, the partners compromised and collaborated to achieve a mutually agreeable turnaround plan. Today, the business is on the road to recovery.

Irreconcilable differences

Of course, not all shareholder disputes end on a positive note. Sometimes owners contemplate legal action. A valuator can help determine whether it's financially feasible to pursue a case. Hiring a valuator as soon in the process as possible improves the efficacy of discovery, increases the likelihood of out-of-court settlement and provides adequate time for the expert to perform a comprehensive analysis.

Valuators often serve as expert witnesses in shareholder litigation. A valuation expert might provide testimony concerning:

- The fair market value of the business, including the fair value of each shareholder's interest,
- Economic damages, including temporary lost profits and diminution in business value,
- Formal rebuttal of an opposing expert's conclusions,
- Reasonable compensation for shareholder-employees, and
- Appropriate discounts for lack of control and marketability, depending on relevant legal precedent.

A valuator also may serve as consultant, helping the attorney critique the opposing expert's report and prepare questions for deposition and trial. But a valuator shouldn't serve as both expert witness and consultant on the same case. Keeping these roles separate helps prevent a valuator from being perceived as a "hired gun" by judges, juries and mediators.

Unbiased support

Shareholders often butt heads, whether it's about past events or a business's future direction. When differences of opinion impair performance, it's time to call for professional advice. Valuators are objective outsiders who can defuse emotions and refocus the parties' attention on the cold, hard financial facts. ●

Court rejects shortcut in favor of detailed analysis

A common rule of thumb for calculating reasonable royalties in patent infringement cases has been to presume the inventor and manufacturer split pretax profits 25/75. But now in *Uniloc USA Inc. v. Microsoft Corporation*, the U.S. Court of Appeals for the Federal Circuit called this methodology "fundamentally flawed."

The case arose when Uniloc alleged that copy-protection features of certain Microsoft products violated Uniloc's patent on a registration system that deters unauthorized copying of software.

Uniloc's expert based his damages calculation on a prelitigation Microsoft document that valued the copy-protection feature between $10 and $10,000, depending on usage. The expert applied a 25% profit split to the bottom of this range, yielding a "reasonable royalty" of $2.50 per product sold. Based on the expert's methodology, the trial court awarded $388 million in damages.

The Federal Circuit, however, decided that the 25% rule is too generous to the owner of a narrow patent, and too stingy to the owner of a broad patent. It also found that the oversimplified rule fails to account for factors like the availability of noninfringing alternative technologies and the risks assumed by the licensee.

The court concluded, "The 25% rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation. Evidence relying on the 25% rule of thumb is thus inadmissible under *Daubert* and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue." Such facts include the patents, products and parties involved in the suit.

This case shows that courts won't blindly substitute rules of thumb for detailed analytical analysis. It also underscores the importance of hiring a credentialed financial expert and establishing a solid connection between an expert's analytical tools and case facts.

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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

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John M. Leask II CPA, LLC.
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More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at ***203 - 255 - 3805.***
The fax is ***203 - 380 - 1289****, and e-mail is* ***Mac@LeaskBV.Com****.*

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.