Intangible Assets in Purchase Price Allocations

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There are numerous reasons why a company will conduct a valuation of its intangible assets. One such reason relates to valuing the intangible assets, and all other assets, that were transferred in the acquisition of the company. As is the case with any valuation, the valuation analyst should be familiar with the assignment purpose and with all compliance matters associated with the intangible asset valuation. This discussion provides an overview of (1) the purchase price allocation analysis procedures and (2) the procedures that analysts consider in the valuation of intangible assets as part of the acquisition accounting.

Introduction

Mergers and acquisitions can trigger many financial and tax reporting requirements for companies. A common requirement for both reporting purposes is accounting for an acquisition by providing a purchase price allocation (PPA) analysis.

A PPA is an allocation of the total purchase price—or total purchase consideration—to the individual assets and the individual liabilities included in the acquisitive transaction. A PPA may be performed for financial or tax reporting purposes and there are differences to understand and consider with each.

In the United States, guidance associated with a PPA for financial reporting purposes is contained in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) topic 805, *Business Combinations*.

Subsequent to all transactions that involve a change in control, companies are required to complete a PPA for financial reporting purposes regardless of whether the transaction is structured as an asset purchase or a stock purchase.

Outside the United States, International Financial Reporting Standards (IFRS) 3R – *Business Combinations*, used by most countries, outlines the accounting for financial reporting purposes when an acquirer obtains control of a business and its underlying assets.

Internal Revenue Code Section 1060 and Section 338 provide procedures for completing the PPA in a taxable business purchase transaction for federal income tax reporting purposes. For federal income tax reporting, companies are only required to complete a transaction PPA for:

1. an asset purchase or
2. a stock purchase for which a Section 338 election is made (which accounts for a stock purchase as if it was an asset purchase).

A business combination is defined by ASC topic 805 as, "a transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations."[1]

A business is defined by ASC topic 805 as, "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants."[2]

Exhibit 1
Some of the Differences in the Purchase Price Measurement

Purchase Price Component	Financial Reporting	Income Tax Reporting
Transaction costs	Not included	Includes certain costs
Deferred taxes	Included	Not included
Accrued liabilities	Included	Partially included
Contingent consideration and liabilities	Included and measured at fair value if contractual and in certain cases if not contractual	Not included
Debt measurement	Measured at fair value	Measured at face value

Differences in PPAs for Financial Reporting and Tax Reporting

Differences including the computed purchase price, standard of value, and valuation procedures and methodology may exist between financial reporting and income tax reporting PPA valuations.

Treatment of Financial Statement Items

First, significant differences may arise in the computed purchase price paid in a transaction as a result of including or excluding certain transaction costs, deferred taxes, and accrued liabilities. Additional differences may arise in the purchase price paid as a result of the inclusion and measurement of contingent consideration and liabilities and the measurement of assumed debt. The differences above are summarized in Exhibit 1.

Standard of Value

Second, the appropriate standard of value is different for PPA valuations performed for financial reporting and tax reporting purposes. For financial reporting purposes, the standard of value is fair value, which is defined by FASB ASC topic 820, *Fair Value Measurements and Disclosures*, as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[3]

However, the appropriate standard of value for U.S. income tax reporting purposes is fair market value, which is defined by the Revenue Ruling 59-60, as "the price at which property would exchange 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 having reasonable knowledge of the relevant facts."[4]

The analyst should be aware that there is no single definition of fair market value that is applicable for all valuation purposes. In fact, similar, but slightly varied, definitions of fair market value are provided by various statutory authority, judicial precedent, and administrative rulings.

In any event, all of the definitions of fair market value incorporate the concept of the hypothetical and unspecified willing buyer and the hypothetical and unspecified willing seller.

In addition to fair value and fair market value, there are other standards of value that exist (i.e., market value, acquisition value, use value, investment value, owner value, insurable value, and collateral value). However, fair value and fair market value are the primary standards of value used in PPAs for financial reporting and income tax reporting purposes, respectively.

It should be noted that, although there may be specific differences between the fair value and fair market value standards, often the value of an asset valued under these standards will be very similar (however, in some cases the value may be materially different).

Valuation Procedures

Finally, differences in the valuation procedures and methods utilized in a PPA may arise in the valuation analyses performed for financial versus tax reporting purposes. Differences include the treatment of bargain purchase transactions, the assignment of goodwill and other asset values, and the consideration of the tax amortization benefit for intangible assets.

The above-listed differences are summarized in Exhibit 2.

Reporting Requirements

Exhibit 3 provides a summary of the authoritative literature that is relevant to financial reporting (for

Exhibit 2
Differences in the Acquired Asset Valuation Approaches and Methods

Topic	Financial Reporting	Income Tax Reporting
Bargain purchases	Gain recognized	Sequential allocation under residual method
Ownership of assets	At the reporting unit level	At the legal entity level
Goodwill allocation	Can allocate to the buyer's preexisting reporting units	Only allocated to acquired entities
Goodwill assignment of value and impairment	Tested at the reporting unit level and assigned at a jurisdictional level	Jurisdictional level and no impairment testing requirements
Tax amortization benefit for intangible assets	Always included	Included only to the extent amortization is tax deductible

both U.S. and outside the U.S.) and income tax reporting (for only the U.S.) for assets acquired and liabilities assumed as part of a business combination.

Assets and Liabilities Included in PPAs

Business combinations involve all classes of tangible assets, intangible assets, and liabilities. Per U.S. GAAP and tax regulations, acquired assets and assumed liabilities are not limited to those previously recognized by the business acquired. Certain assets and liabilities that were not previously recognized by the acquired business must be recognized by the acquirer as of the transaction closing. These typically include any intangible assets that were internally developed (not previously acquired) by the acquired business.

Exhibit 3
Financial Reporting and Income Tax Accounting Requirements

Financial Reporting Requirements:
FASB ASC 805, *Business Combinations*
FASB ASC 820, *Fair Value Measurements and Disclosures*
FASB ASC 350, *Intangibles – Goodwill and Other*
FASB ASC 360, *Impairment or Disposal of Long-Lived Assets*
FASB ASC 852, *Reorganizations*
FASB ASC 740, *Accounting for Income Taxes*
IFRS 3R, *Business Combinations*
IFRS 13, *Fair Value Measurement*
Income Tax Reporting Requirements:
IRC Section 1060
IRC Section 338
IRC Section 197

Exhibit 4 includes, but is not limited to, the types of tangible assets, intangible assets, and liabilities involved in business combinations and purchase price allocations for financial reporting.

Purchase price allocations performed for U.S. income tax reporting purposes are done under the standard of fair market value. Section 1060 and the regulations under Section 338 further identify the classes of assets for income tax reporting purposes presented in Exhibit 5.

The previous discussions were presented to provide a general overview of PPAs, including information on the reporting requirements associated with financial reporting and tax reporting and the types of assets and liabilities that are subject to PPAs.

As discussed previously, assets acquired, liabilities assumed, and other items which are associated with an acquisition, or business combination, have an impact in a PPA. An allocation should be performed to the acquired assets and liabilities, whereby these are recorded at fair value as of the acquisition date for financial reporting purposes.

Exhibit 4
Assets and Liabilities That Are Commonly Valued in PPAs

Real Estate and Real Property Interests	Tangible Personal Property and Related Assets	Intangible Assets	Liabilities
Land	Machinery and equipment	Trademarks	Deferred revenue
Land improvements	Furniture and fixtures	Patented technology	Contingent consideration
Buildings	Computer equipment	Customer relationships	Contingent liabilities
Leasehold interests	Vehicles	Favorable supply agreements	
Leasehold improvements	Construction in progress	Noncompete agreements	
		License agreements	
		Internal-use software	

Valuation Procedures

For the remainder of this discussion, the focus relates to PPAs as part of financial reporting for presentation purposes only. Furthermore, a discussion of intangible assets as they pertain to financial reporting and PPAs will be an additional area of focus. However, it should be noted there are several similarities and differences (some of which were highlighted previously) between PPAs and the valuation of intangible assets for both financial reporting and tax reporting purposes.

Intangible Assets[5]

ASC 805 defines an intangible asset as, "an asset (not including a financial asset) that lacks physical substance." An intangible asset excludes goodwill as noted by ASC topic 805. As part of a business combination, an acquirer recognizes separately from goodwill the identifiable intangible assets purchased.

An intangible asset is considered to be identifiable if either of the following conditions exist:

1. It is separable—that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually, or together with a related contract, identifiable asset, or liability, regardless of the intentions of the entity (which is known as the separability criterion)
2. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (which is known as the contractual-legal criterion).

Exhibit 5
Asset Classes for Income Tax Reporting Purposes

Class	
Class I	Cash and cash equivalents
Class II	Marketable securities
Class III	Other assets marked to market annually
Class IV	Inventory
Class V	Land, buildings, and personal property
Class VI	IRC Section 197 – *Intangible Assets*
Class VII	Goodwill and going concern value

Contractual-Legal Criterion

An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable, or separable, from the business acquired or from other rights and obligations.

The list below presents examples for illustration purposes.

1. An acquired business leases a manufacturing facility under an operating lease that has terms that are favorable relative to market terms. The lease terms explicitly prohibit transfer of the lease (through either sale or sublease).

The amount by which the lease terms are favorable compared with the pricing of current market transactions for the same or similar items is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even though the acquirer cannot sell or otherwise transfer the lease contract.

2. An acquired business owns a technology patent. The business has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange.

   Both the technology patent and the related license agreement meet the contractual-legal criterion for recognition separately from goodwill, even if selling or exchanging the patent and the related license agreement separately from one another would not be practical.

Many intangible assets arise from rights conveyed legally by contract, statute, or similar means. For example, franchises are granted to automobile dealers, fast food outlets, and professional sports teams; contracts can be negotiated with customers and suppliers; and patents often protect technological and scientific innovations.

The FASB determined that an intangible asset arising from contractual or other legal rights is an important characteristic that distinguishes many intangible assets from goodwill, and an acquired intangible asset with that characteristic should be recognized separately from goodwill.

All intangible assets acquired in a business combination that meet the contractual-legal criterion are recognized at the date of acquisition. Some intangible assets that meet the contractual-legal criterion may also be separable. However, it should be noted that according to guidance in ASC topic 805, separability is not a requirement for an intangible asset that meets the contractual-legal requirement to be recognized.

Separability Criterion

The separability criterion means that an acquired intangible asset is capable of being separated or divided from the business acquired and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability.

An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something else of value would be considered to meet the separability criterion even if the acquirer does not intend to sell, license, or otherwise exchange it.

An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them. For example, customer lists are frequently licensed and are considered to meet the separability criterion.

Even if an acquired business believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion.

However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers.

An intangible asset meets the separability criterion if it is capable of being sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. Thus, only the capability of an asset to be separated from the entity and exchanged for something else of value is required, not the intent to do so by the management of the business acquired.

If an intangible asset is not capable of being separated from the entity by itself, but can be combined with a related contract, identifiable asset, or liability and separated, the separability criterion is met.

ASC topic 805 defines goodwill as, "an asset representing the future economic benefits arising from other assets acquired in a business combination . . . that are not individually identified and separately recognized."

An intangible asset that does not meet either the separability criterion or the legal-contractual criterion at the date of acquisition is considered to be included in goodwill.

Likewise, any value attributable to items that do not qualify as assets at the date of acquisition are considered to be included in goodwill. An assembled workforce and future customer relationships are examples of items that are not identifiable intangible assets, and thus are not recognized separately but are considered to be included in goodwill.

Examples of Identifiable Intangible Assets

Exhibit 6 presents a list of intangible assets that meet the identifiable criteria (i.e., that either arise

Exhibit 6
Identifiable Intangible Assets

Intangible Asset Type	Contractual/Legal Criterion	Separable Criterion
Marketing-related	Trademarks and trade names Service marks, collective marks, and certification marks Newspaper mastheads Internet domain names Noncompetition agreements	
Customer-related	Order or production backlog Customer contracts and related customer relationships	Customer lists Noncontractual customer relationships
Artistic-related	Plays, operas, ballets Books, magazines, newspapers, and other literary works Musical works, including compositions and song lyrics Pictures and photographs Video and audiovisual material, including motion pictures or films, music videos, and television programs	
Contract-based	Licensing, royalty, and standstill agreements Advertising, construction, management, or supply contracts Lease agreements Construction permits Franchise agreements Operating and broadcast rights Use rights (e.g., drilling, water, air, mineral, and route authorities) Servicing contracts (e.g., mortgage servicing) Employment contracts	
Technology-based	Patented technology Computer software Trade secrets (e.g., secret formulas, processes, and recipes)	Unpatented technology Databases In-process research and development

from contractual-legal rights or are separable) for recognition as intangible assets apart from goodwill. This list is not intended to be inclusive of all identifiable intangible assets that may exist, but it is only for presentation purposes.

The analyst should perform sufficient due diligence including a thorough industry research, discussions with the acquirer and the business acquired, discussions with the acquirer's external auditors (including their respective valuation teams who may be providing assistance to the auditors), and the analyst's prior experience in determining the appropriate identifiable intangible assets within all purchase price allocations and business combinations.

Market Participant and Highest and Best Use Concepts

As noted previously, the standard of value for financial reporting purposes is fair value, which is defined by ASC topic 820, as, "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." It is important for the analyst to understand the market participant and highest and best use (HABU) concepts for financial reporting purposes.

ASC topic 820 defines market participants as, "buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

1. They are independent of each other, that is, they are not related parties, although the price of a related party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms.
2. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.
3. They are able to enter into a transaction for the asset or liability.
4. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so."

A reporting entity will measure the fair value of an asset or a liability using the assumptions that market participants would use in pricing the asset or liability, assuming that market participants act in their economic best interest. In developing those assumptions, the reporting entity need not identify specific market participants.

Rather, the reporting entity will identify characteristics that distinguish market participants generally, considering factors specific to all of the following:

1. The asset or liability
2. The principal (or most advantageous) market for the asset or liability
3. Market participants with whom the reporting entity would enter into a transaction in that market

HABU is a valuation concept that refers broadly to the use of an asset in a manner that would maximize the value of the asset or group of assets to market participants, even if the intended use of the asset by the entity is different. A fair value measurement assumes the HABU of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date.

As an example, an entity may intend to continue the operations of a recently acquired asset in a business combination as a manufacturing facility; if market participants consider the HABU of the asset as residential property because it will produce a greater fair value, then the fair value measurement would be considered from the perspective of market participants as residential property rather than the entity's intended use as a manufacturing facility.

The fair value measurement would reflect the costs and risks associated with the change to this HABU.

The HABU valuation concept only applies to nonfinancial assets (e.g., real estate and intangible assets). The valuation concept of HABU does not apply to liabilities. This is because the fair value measurement for liabilities assumes the liability is transferred to a market participant in its existing condition (including credit-standing) at the measurement date. Additionally, the concept does not apply to financial assets.

Under the HABU valuation concept, the fair value of an asset is measured in combination with other assets as a group or under a stand-alone valuation premise. When the HABU is determined to be in combination with other assets and liabilities as a group, the valuation premise assumes the HABU of an asset will provide maximum value to market participants if combined with other assets as a group and that those assets are already owned or are available to market participants.

The stand-alone valuation premise assumes the HABU of an asset will provide maximum value to market participants if used on a stand-alone basis. Assumptions about the HABU of a nonfinancial asset would need to be consistent for all of the assets (for which HABU is relevant) of the collective group of assets within which the asset would be used.

A reporting entity's current use of a nonfinancial asset is presumed to be its HABU unless market or other factors suggest that a different use by market participants would maximize the value of the asset.

Intangible Asset Valuation Approaches and Methods

Generally accepted valuation practice indicates that assets may be valued using a range of methods. These methods can be broadly classified into three general approaches: the income, market, and cost/asset-based approaches.

In any valuation analysis, all three approaches are considered. The approach or approaches deemed most indicative of value are then selected as the proper approach(es) to use for the assets being valued.

Under the income approach, fair value is determined using valuation methods to convert future amounts (e.g., cash flow or earnings) to a single present amount.

One of the most common valuation methods under the income approach is the discounted cash flow method. Under that method, the entity first estimates the net cash flow expected to accrue directly or indirectly from ownership of the asset. Second, the entity discounts those future cash flows to their present value using an appropriate discount rate converting the cash flow or earnings to a single present amount.

Variations of the discounted cash flow method are often used to value intangible assets, including, but not limited to: the multi-period excess earnings method, the relief from royalty method, and the incremental cash flow method. A component in any discounted cash flow analysis is the discount rate and, generally, the discount rate should be commensurate with the risk associated with the cash flows reflecting market participant expectations of risk and return for the particular asset or liability.

The market approach measures the value of an asset through an analysis of recent sales or offerings of comparable assets that have been recently acquired in arm's-length transactions. The market data are then adjusted for any significant differences, to the extent known, between the identified comparable assets and the asset being valued.

A benefit of the market approach is its simple application when comparable transactions are available. This situation is most commonly found when the acquired asset is widely marketed to third parties. Under these circumstances, the market comparable method represents the most appropriate method for determining the fair value of the asset.

The primary drawback of the market approach is often the scarcity of data regarding comparable transactions within a recent date upon which to establish fair value.

The cost approach establishes a value based on the cost of reproducing or replacing the asset, often referred to as current replacement cost. From the perspective of a market participant, the price received for an asset is estimated based on the cost to a market participant to reproduce or to replace the asset with a substitute asset of comparable utility.

For nonfinancial assets, the valuation process under the cost approach typically begins with an estimation of the asset's replacement cost adjusted, where applicable, for obsolescence to estimate the replacement cost of the asset's current service potential. Obsolescence includes physical depreciation, functional or technological obsolescence, and economic obsolescence.

PPA Supporting Analyses

Other analyses that are typically required in performing a PPA for financial reporting purposes include a weighted average cost of capital (WACC) analysis, an internal rate of return (IRR) analysis, and a weighted average return on assets (WARA) analysis.

These analyses are discussed, in depth, in the discussion "Discount Rates in a Purchase Price Allocation" by David Turney in this *Insights* issue.

Summary and Conclusion

PPAs performed in order to comply with financial reporting and income tax reporting regulations can be a very complex and challenging exercise. The analyst performing a PPA valuation should understand (1) the appropriate professional standards and compliance areas, (2) the best practices from a valuation perspective, (3) the types of assets, liabilities, and interests involved in the business combination transaction, and (4) the appropriate valuation approaches and methods to use.

Furthermore, the analyst should work closely with the client, or company management (and members from groups within the financial reporting and tax reporting areas at the company), and discuss how a transaction and the conclusions from a valuation provider can be useful to the subject company in the future as it pertains to other areas that may be affected.

Notes:

1. FASB ASC topic 805 – *Business Combinations*.
2. Ibid.
3. FASB ASC topic 820 – *Fair Value Measurements and Disclosures*.
4. Revenue Ruling 59-60.
5. FASB ASC topic 805.

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