

VALUATION MATTERS

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Valuing Intangibles for Financial Reporting: Understanding the Interplay of FASB Statements

Twenty years ago, most mergers and acquisitions involved the traditional “bricks and mortar” companies, and most of the assets were tangible: real estate, plant, property, and equipment. The old accounting rules, which governed purchase price allocations, tended to throw everything into goodwill, amortized over forty years.

But the Internet changed the focus of the U.S. economy to assets of the “Information Age” and transactions involving technology companies. The Financial Accounting Standards Board (FASB) began looking at the billions of dollars in business combinations being allocated to goodwill and decided that, in an acquisition, the fair value of specific intangible assets should be recognized and placed on the balance sheet, amortized over a remaining useful life. That’s when FASB Statements of Financial Accounting Standards (SFAS) No. 141, 141R, and 142 appeared on the scene.

At about the same time, the FASB began working on its Convergence Project with the International Accounting Standards Board to bring U.S. GAAP – which takes a historic cost-based approach – more in line with International GAAP, which focuses on current values. So now there are more M&A transactions with assets tilted toward intangibles, and more of these are taking place in a global marketplace, hence the need for a sound understanding regarding intangible valuations.

Identifying intangibles

Paragraph 39 of SFAS 141 (Business Combinations) states: An intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights or, if not contractual, only if it is capable of being sold, transferred, licensed, rented or exchanged. Examples of intangible assets that meet these criteria are:

Marketing-related: trademarks, trade names, trade

dress, Internet domain names;

Customer-related:

customer lists, order backlog, customer relationships;

Artistic-related: plays, books, videos, musical works;

Contract-based: licensing rights, supply contracts, leases, franchise rights; and,

Technology-based: patents, software, databases, trade secrets, IPR&D (in-process research and development).

Generally, SFAS 141 provides for allocation of the identifiable intangibles on the date of acquisition, and then SFAS 142 (Goodwill and Other Intangible Assets) provides a test for impairment of those assets in the years following the acquisition, as these assets are no longer amortized. SFAS 142 also tests for impairment of indefinite-lived intangible assets (such as a trade name) for which a useful life may not be readily estimated.

Additionally, in its currently proposed Statement 141R (Business Combinations: Applying the Acquisition Method), the FASB would require contingent assets and liabilities to be recorded at their fair values as of the acquisition date. Similarly, 141R would capitalize IPR&D – technology that’s in process as of the acquisition date but not fully developed; it would be considered an indefinite-lived intangible asset until it became developed, at which point a life would be assigned. This revised statement will eventually create an even greater emphasis on estimating the fair value of IPR&D.

Finally, SFAS 144 (Accounting for the Impairment or Disposal of Long-Lived Assets) governs the impairment testing for definite-lived intangible (and tangible) assets, which are subject to amortization in the years following the acquisition.

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■ *Idaho Considers Distinction Between Personal and Enterprise Goodwill*

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Idaho Considers Distinction Between Personal and Enterprise Goodwill

**Stewart v. Stewart, 2007 Ida. LEXIS 17
(January 26, 2007)**

In a case of first impression, the Idaho Supreme Court recently considered whether to distinguish enterprise goodwill (divisible marital property) from personal goodwill (non-marital, non-divisible) in a divorce proceeding. Currently, a majority of U.S. state courts have adopted this distinction, while the minority include both enterprise and personal goodwill in the marital estate. (Approximately four states have held that neither form of goodwill is marital, while just about the same number of states have yet to decide or clearly define the issue.)

In the Stewart case, the husband, a dermatologist, owned a 45% share in a dermatology clinic. When the parties divorced, the trial court valued the tangible assets of the practice at just over \$130,000, with an additional \$211,000 of “professional” goodwill, separate and above what might be ascribed to the husband’s individual talents and skill. As prior law held that goodwill was an appropriate factor in determining the value of a business, the court deemed this component of the clinic to be marital property and divided it between the parties.

The husband appealed, arguing that goodwill was not an appropriate factor to consider in valuing a professional practice. The state Supreme Court disagreed, finding “no principled reason to treat the goodwill of a business differently when it is a professional services corporation.” The determination may be more difficult to make, since Idaho law also states that a professional’s personal skill and knowledge (attributable to degrees, licenses, individual experience, and talents) are not property, either separate or community.

But “where a professional business is an independent entity...goodwill is calculable and divisible in divorce just as goodwill in any other business.” Because the dermatology practice was just such an entity, the trial court was capable of distinguishing its “identity” from the husband’s, and to the extent the practice had goodwill value beyond the husband’s individual attributes, “that goodwill is community property.”

Clarifying concurrence and strong dissent

The language of the majority – alluding to the “personal” skills and knowledge of the husband as his “assets,” distinct from those of the business – makes this portion of the Stewart opinion confusing, as it’s not clear how these “personal” attributes differ from the asset(s) of “personal goodwill.” It’s a common confusion, however, which has

bedeviled most courts and divorce parties and led in part to the divergence among states’ laws on the issue.

But the Stewart concurrence makes it very clear that the Court characterized the goodwill of a business, whether a professional practice or other, as community property, subject to division on divorce, without any distinction between the enterprise or personal components. Thus:

[The Court] declined to enter the “morass” of trying to distinguish between the values attributable to a professional practice by virtue of the individual attributes of the professional and the value of the goodwill not attributable to those personal assets, valuing each separately and then dividing the latter but not the former.

“Quite frankly,” the concurrence concludes, “such an approach does not make a good deal of sense.”

While the professional attributes and skills of the marital partners are not community property [themselves], the employment of those attributes and skills during the course of the marriage can produce a value in a business, whether professional or otherwise, that becomes community property. (Emphasis added.)

As with professional attributes, the concurrence went on to say, personal attributes – including knowledge, background, and talent – are not in themselves community property. But personal attributes can enhance the value of a business, including a professional practice, thus creating value that is community property.

But one judge strongly dissented. The wife’s appraisal expert, a CPA, valued the goodwill of the husband’s practice using a capitalization of excess earnings [this term is not usually capitalized] approach. He deducted the average annual income for dermatologists nationwide (from a medical industry survey) from the husband’s average annual income for three years to obtain an excess earnings figure, capitalized by a selected rate to produce a present value of what the CPA called, without distinction, “goodwill.”

“The issue is whether the capitalization of excess earnings approach provides a value for a community asset,” according to the dissent, “where the spouse’s income is derived from personally providing services to patients, clients, or customers.” At its most basic level, the question becomes whether the present value of the husband’s ability to earn above-average income is community property. As the majority noted, Idaho law states that a spouse’s personal attributes – including knowledge, skill, reputation, etc. – are not *(continued on next page)*

Court Opens Door to Appraiser Liability in Buy-Sell Context

Wetmore v. Macdonald, Page, Schatz, Fletcher & Co., LLC, 2007 U.S. App. LEXIS 3116 (February 12, 2007)

Two owners of a closely held business invoked the deadlock-breaking provision of their buy-sell agreement, which provided that they each had the right to acquire the other's stock, first by obtaining a valuation by a named appraiser (Macdonald Page), and then by asserting the right to buy out the other's interest "at a price equal to or greater than the price determined by the accountant." The valuation thus served as a bidding floor in the negotiations.

Based on the \$1+ million appraisal, the 40% minority owner offered to buy out the 60% majority owner (the plaintiff) at approximately 60% of the value, minus a small marketability discount. The majority owner refused, countering with a \$1.25 million offer for the 40% shares, plus a noncompete. His offer was turned down and, on the threat of a lawsuit to "force" him to sell his shares at the original price, he relented and sold out to the minority owner. He then sued MacDonald Page for breach of contract, professional negligence, and misrepresentation in performing a "deficient" valuation, which he claimed was "well less than half the actual value" of the company's stock.

Causation is key

At trial, the U.S. District Court granted Macdonald Page's motion to dismiss, based largely on lack of causation. Nothing in the agreement required the plaintiff to accept the minority owner's offer, the Court said. He could have upped his offers or "challenged the appraisal in any number of ways."

On appeal, the First Circuit agreed that causation was critical – as was its review of the motion to dismiss, which required accepting all allegations as true. Under this standard, "to say that a negligently-arrived-at valuation that set an artificially low floor would not have a substantial

effect on a shareholder in [the plaintiff's] position ignores the logic of cause and effect." The plaintiff had the absolute right to accept the minority owner's offer, so long as it equaled or exceeded the MacDonald Page valuation. "And that meant he had the right to rely on MacDonald Page to generate a valuation that set a fair price for the shares."

Further, the plaintiff's "injury" was entirely foreseeable, the Court of Appeals said. Any misfeasance by the appraiser would impose the precise bind that shareholders in a close corporation seek to avoid by executing a buy-sell agreement. With a negligent valuation, the buy-sell protections become "meaningless." The Court reversed and remanded for further proceedings. The plaintiff will still need to meet its burden of proof concerning liability, but for now, the case exposes appraisers to claims of negligent valuation in the buy-sell context.

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divisible community property. Thus, according to the dissent, the Court should have required the parties to distinguish whether the husband's ability to earn above-average income was based on his personal attributes or "some other factor."

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William J. Piccerelli, CPA, CVA

Bill's forty years of public accounting experience provides him with an extensive background covering not only technical financial accounting matters, but also business valuations and litigation support. A Certified Valuation Analyst and one of the Firm's founding partners, he has extensive valuation experience and has served as a financial consultant and expert to matrimonial and corporate attorneys. He has testified as an expert witness in Federal, Superior and Family Court. Bill graduated Summa Cum Laude from Bryant College with a Bachelor of Science Degree in Accounting. He is a member of the National Association of Certified Valuation Analysts (NACVA). Bill was recently recognized by the Rhode Island Society of Certified Public Accountants and awarded the Distinguished Service to the Profession Award. Contact Bill at billp@pgco.com or 401-831-0200.

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Factoring FAS 157 into intangible valuations

There are now nearly three dozen FASB Statements that mention fair value, and FAS 157 (Fair Value Measurements) attempts to clarify these by: (a) defining fair value; (b) establishing a framework for measuring fair value in GAAP; and (c) expanding disclosures about fair value measurements. (Note: SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007.)

In this context, the FASB is trying to match the actual transactions taking place with their purpose and their pricing value from an exit perspective. Compared to the definition of fair value in FAS 141, the definition in FAS 157 is much cleaner:

SFAS141: “Fair value 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.”

SFAS157: “Fair value is 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.”

Of course, this still raises questions regarding “market participants” and “orderly transaction,” but in general, SFAS 157’s definition of fair value is much closer to fair market value. Because it theoretically eliminates synergies from any particular buyer, SFAS 157’s definition is not as close to investment value, unless the market participants would generally recognize them.

Reconciling fair value for financial reporting with other purposes

It’s critical to understand the nuances between the various FASB Statements and their requirements. There is a difference between valuing intangible assets for financial reporting and for other purposes, and some of the methodologies recommended in the FASB pronouncements may not be appropriate in other venues. Essentially, a valuation for financial reporting purposes should follow the dictates of its particular context, which may not be applicable to another involving a different standard of value.

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