

# Alert

October 2003

## Customer-Related Intangible Assets Important Consideration for Buyers

*"In order to avoid any unpleasant surprises, buyers should pay attention up front to the required accounting for intangible assets."*

When buying a company, acquirers spend a significant amount of time on financing, due diligence, and planning for integration. Yet, despite a substantial discrepancy between how acquirers evaluate acquisition targets and how the Financial Accounting Standards Board (FASB) wants buyers to account for their acquired values, buyers generally review the transaction's accounting requirements *after* completing the deal. In order to avoid any unpleasant surprises, buyers should be paying attention up front to the required accounting for intangible assets, in particular, customer-related intangibles. This may involve a preliminary valuation exercise as part of the due diligence process.

### IMPACT OF SFAS 141

In Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*, the FASB stated that the following categories of intangible assets have to be recognized apart from goodwill: marketing-related, customer-related, artistic-related, contract-based and technology-based. Intangible assets that are identified must then be measured at fair value. The following intangibles are included in the category of customer-related intangibles: customer lists, order backlog, customer contracts and related customer relationships, and noncontractual customer relationships.

SFAS 141 defines the term "customer relationship" as the following:

*For purposes of this statement, a customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make direct contact with the entity. Relationships may arise from contracts (such as supplier contracts and service contracts). However, customer relationships may arise through means other than contracts, such as through regular contact by sales or service representatives.*

The FASB was uncomfortable with the concept of customer relationships based on habit and tradition. In issuing SFAS 141 the Board decided that, for accounting purposes, customer-related intangibles either had to be based on legal rights in a contract or had to be severable and marketable on a separate basis. While the FASB had to come up with criteria for which intangibles should be recognized apart from goodwill, the separability or contractual criteria fails to capture the complete spectrum of customer/vendor relationships.

The way the Board initially chose to define customer-related intangible assets has resulted in most of these assets being included in goodwill. While buyers may be pleased with this result since future charges to earnings will be less, readers of financial statements might not fully appreciate what the buyer really acquired. After the issuance of SFAS 141, the FASB later

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### VRC NEWS

VRC will be presenting a webcast, "Valuing Customer-Related Intangibles," on October 21, 2003. Register at [www.valuationresearch.com/registration.htm](http://www.valuationresearch.com/registration.htm)

## Customer-Related Intangibles Important Consideration for Buyers

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decided to issue an "interpretation" of SFAS 141 to address questions concerning the application of paragraphs 19-21 to customer-related intangibles including order or production backlog, customer contracts and related customer relationships, and noncontractual customer relationships. In October 2002, The Emerging Issues Task Force (EITF) issued EITF 02-17: "Recognition of Customer Relationship Assets Acquired in a Business Combination."

### DECISIONS FROM THE EITF

The EITF decided that renewals and other benefits associated with a customer relationship should be considered regardless of whether it meets contractual, legal or separable criteria. In addition, the EITF decided that as long as a company had even a single purchase order from a customer on the closing date of the acquisition, then that meets the "test" of a contractual relationship. Further, the value of a relationship would not be just the the single order covered by the purchase order but all expected future orders. In other words, a single purchase order was enough to sweep in all future business, whether contractual or not.

The EITF determined that although customer lists do not arise from contractual or legal rights, they can be rented or sold and therefore fit the separability criteria for recognition apart from goodwill. If there is a restrictive agreement as part of an acquisition which prohibits the company from selling or renting the lists, the lists would not qualify as being separable. In the case of customer contracts, regardless of whether there is a restrictive agreement as part of an acquisition which prohibits the company from selling or renting the lists, they should still be valued. The valuation method should be based upon facts and circumstances, and the income and cost approaches were recognized by the EITF as the most common approaches to use.

### SEC SCRUTINY

One final note about intangible assets, we have been finding in recent engagements that the SEC is scrutinizing intangibles with indefinite lives. One of our clients had a distributor network classified as having an indefinite life. We had calculated for the client the cost to replace the distributor network. The SEC went back to the client and asked for opportunity costs in addition to the replacement costs previously provided. We then determined the cost to recreate lost business opportunities.

In conclusion, most transactions will have customer relationships that need to be valued. Our recommendation is for the company to obtain an estimate of the value of intangible assets and goodwill *prior to* an acquisition. As a buyer, knowing the value of the underlying assets will allow you to determine whether or not a proposed acquisition will be accretive to earnings per share. For further information regarding customer-related intangibles, contact your Valuation Research representative or Alfred King at (609) 243-7013. **VR**

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