

Alert

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Pre-Acquisition Valuations Critical to Consummation of Deals

“Publicly traded firms are sensitive to reported earnings per share, which will be affected by intangible asset amortization.”

When buying a company, acquirers spend a significant amount of time on financing and planning for integration. Yet, buyers often 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.

The issuance of SFAS 141 and SFAS 142 has made it critical for buyers and sellers to consider how a transaction may impact financial reporting. Further, it is necessary to project as accurately as possible the future charges to expense related to the amortization of intangible assets. Publicly traded firms are sensitive to reported earnings per share, which will be affected by intangible asset amortization. Companies should make acquisitions only after evaluating the effect that the amortization of intangible assets will have on future earnings. Acquirers will often ask a valuation expert to prepare a pre-acquisition valuation.

INTANGIBLE ASSETS

In today's technologically driven economy, intangible assets are frequently the key assets in an acquisition. For this reason, when drafting SFAS 141, the FASB created categories of intangibles (customer-based, contract-based, marketing-related, etc.) and mandated recognition of these intangibles apart from goodwill. Identifying and valuing intangible assets in advance of a purchase has become a necessary step in the due diligence process. Our pre-acquisition valuations have frequently been used as "evidence" to show whether an acquisition will be accretive. Here are some examples that illustrate the importance of obtaining a valuation of intangibles prior to a transaction:

- A global public company was considering the acquisition of an early stage value-added supplier of biotechnology products. We were asked to value the material intangible assets of the target company. In an initial review of the Company, we and the client believed the technology and IPR&D would encompass a significant portion of the purchase price. In the course of our analysis we found that the technology and IPR&D comprised only a small percentage of the purchase price because of the rapid rate at which the technology was evolving. Based on our value and life conclusions our client concluded that the acquisition would be accretive to earnings.
- A U.S. public company was considering the acquisition of a privately held company based in the UK. We were asked to value the material intangible assets of the target company. The intangible assets identified in the initial review were trademarks, technology and customer relationships. In the course of our due diligence we found that the target had expensed their recently installed ERP software. In our pre-acquisition

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allocation we valued the software and determined the expected remaining life enabling our client to get a better estimate of the amortization resulting from the acquisition. Based on our value and life conclusions our client concluded that the acquisition would be accretive to earnings.

“As a buyer, knowing the value of the underlying assets will allow you to determine whether or not a proposed acquisition will be accretive.”

- A U.S. public company which provides outsourced computer services was considering the acquisition of a privately held competitor. We were asked to value the target company's customer relationships. Based on our value and life conclusions our client concluded that the acquisition would be accretive to earnings.

- A public company which provides services to the pharmaceutical industry was considering the acquisition of a privately held company. We were asked to value the material intangible assets of the target company. The intangibles identified during the initial review were trademarks, technology and customer relationships. Based on our value and life conclusions our client concluded that the acquisition would be accretive to earnings.

- A global industrial conglomerate was considering the acquisition of an early stage technology company. We were asked to review the materiality of IPR&D prior to the acquisition. The Company was concerned of the effect a charge (albeit a one time charge) would have on its earnings for the current fiscal year.

In conclusion, most transactions will have intangible assets 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 and lives of the assets to be acquired will allow you to determine whether or not a proposed acquisition will be accretive.

A final note regarding SFAS 141, *Business Combinations*. The FASB plans to make additional changes to SFAS 141 in the second quarter. These changes are part of Phase Two of the implementation of SFAS 141. Key changes include discontinuing the immediate expensing of acquired IPR&D, and fair value recognition of contingent assets and liabilities acquired in a business combination. We will keep you apprised of developments in future issues of this newsletter. For further information regarding the valuation of intangible assets, contact your Valuation Research representative or PJ Patel at 609/243-7030. **VR**

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