

Valuation Challenge: Intangible Assets

The Challenge:

You are considering the acquisition of a company. There are numerous intangible assets that will be acquired. If the acquired intangible assets do not maintain their values, how and when are they written down? How is the goodwill accounted for after the acquisition?

Answer:

Goodwill is what makes the company as a whole worth more than the sum of its individual parts and is initially measured as a residual. To determine the implied fair value of goodwill, the fair value of a reporting unit, which is the amount at which the unit as a whole could be bought or sold, is measured first. If available, quoted market prices in active markets are the best evidence of fair value and should be used in most cases. Otherwise, the fair value of a reporting unit could be measured using prices of comparable businesses or valuation techniques, such as the present-value technique.

The fair value of a reporting unit is treated as if it were the purchase price of an acquired business and is allocated to the assets and liabilities of the reporting unit (whether recognized or unrecognized), similar to the way the purchase price of an acquired business is allocated to the acquired net assets. The excess fair value over the amount allocated to the assets and liabilities of a reporting unit is the implied fair value of goodwill.

On annual basis after the acquisition, the goodwill impairment test is performed to make a comparison of the fair value of a reporting unit with its carrying amount. If the fair value of a reporting unit exceeds its carrying amount, goodwill is not considered impaired. If the carrying amount of a reporting unit exceeds its fair value, the second step of the impairment test is performed to measure the amount of the impairment loss, if any.

In step 2, the company estimates the fair value of the reporting unit's goodwill by repeating the process performed at acquisition. This requires subtracting estimated current fair values of the acquired identifiable net assets from the estimated fair value, and comparing the difference with the carrying amount of the goodwill. When implied fair value is greater than the carrying amount of goodwill, goodwill is not impaired and there is no write-off. When the implied fair value is less than the carrying amount of goodwill, however, the company must record an impairment write-off equal to the difference. If there is an impairment of the assets, the values must be written down. The impairment losses are not reversible.

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