

BLUE SKY

Intangible Assets Your Accounting Misses

What is it & Why You Should Know

By: Randall K. Schostag, CFA, MCBA, ASA, AVA, BVAL¹

Abstract: How do you explain the difference between the business value and the selling price, the 'true value' and the reported book value²? How is goodwill different from customer lists, trade names, or other intangibles? Why do accountants now require that these various asset categories be identified and valued, and why should you know about them? Our goal is to help you appreciate the value of intangible assets in the businesses. Along the way you'll learn how your personal value helps build value in your employer business and why it's not true that all of you company assets walk out the door every night.



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² The term "value" can mean many things. There is fair value, fair market value, investment value, intrinsic value, etc. During this discussion we will assume that the transaction value of the business is equal to the fair value of its assets and liabilities.

We will show you why recognizing underlying intangible assets can help owners better assess business value and important value drivers as well as to show those of you who are not owners more about your contribution.

The door to the procedures we'll discuss was opened by the accounting profession, specifically by the Financial Accounting Standards Board (FASB). During 2001, FASB adopted new requirements for accountants that significantly changed the way we look at a company's intangible assets. FASB passed two Statements of Financial Accounting Standards (SFAS), number 141 and 142.³



You may have heard about these new standards, but thought the new rules pertain only to public companies, or heard only the pain the new requirements have created for companies that must comply. You may think the standards are mysterious and esoteric, and only accessible to those who have attained certification as a public accountant. We believe that the new measures are good, that they are not arcane, and that they can help you better understand business.

In mergers and acquisitions, the new measures place a much needed focus into critical assets that drive companies. The rules for now capitalize intangibles only when businesses are sold. But understanding the principles will help you better understand your business right now.

³ Our focus is on SFAS 141, which relates only to business combinations, viz., one company purchasing another. We believe that FASB is moving to broaden this concept to other purchases and to going concern accounting.

Even if you are not an accountant, and even if your company is not audited⁴, you should be familiar with SFAS 141 and 142. Your business generally and your contribution will be more successful by knowing more about *Blue Sky*.

What is *Blue Sky*?



The *Michigan Auto Dealer* states there are three basic approaches to valuing an automobile dealership: the asset approach, the earnings approach, and the *Blue Sky* approach.⁵

The auto dealer definition differs from conventional valuation approaches, which list the asset approach, the income approach, and the market approach.⁶

We believe the approaches are comparable, using different names to express the same thing. The *Blue Sky* approach develops a value based on earnings and then adds this to the value of the tangible assets.



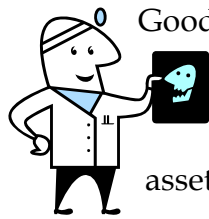
The auto dealer *Blue Sky* definition is more descriptive than the conventional valuation definition, alerting buyers and sellers to an important element in the transaction: the reported asset value carried on the accounting statement compared to the underlying value of the business. The *Michigan Auto*

⁴ We use the term "audit" from a financial, accounting perspective, and not from an IRS, tax perspective.

⁵ "Valuing an Automobile Dealership," [online] Michigan Auto Dealer, cited November 25, 2003, available from <<http://www.michiganautodealer.com/Valuing.html>>.

⁶ Shannon; Reilly Pratt, Robert; Schweihs, Robert, *Valuing a Business* (New York: McGraw-Hill, 2000), p. 45.

Dealer defines *Blue Sky* as “that value ... over and above the value of the hard assets.” International Business Associates⁷ in its online dictionary states that *Blue Sky* as a synonym for goodwill.



Goodwill Registry⁸. Like the *Blue Sky* approach for auto dealers, this method determines a going concern value that is added to net asset value.

The American Heritage Dictionary⁹ provides insight into popular opinions about *Blue Sky*, noting that as an adjective, the term can be interpreted to mean “unrealistic and impractical...” State legislators apparently also considered *Blue Sky* to be negative, passing *Blue Sky laws* that cover the offering and sale of securities, specifically with provisions to prevent *fraudulent* activity and require licensing of brokers.¹⁰

While *Blue Sky* has a tarnished history, we know that reputation is wrong, and so do the business owners. Often business owners inquire about a *valuation*

⁷ International Business Associates, Portland, Oregon. Wickander, James E., "Dictionary," [online] International Business Associates (IBA), 2003, cited November 25, 2003, available from <<http://www.aracnet.com/%7Ejwikand/iba/dict/>>.

⁸ Dietrich, Mark O., CPA, ABV, *Medical Practice Valuation Guidebook, 2001/2002* (Windsor Professional Information, 2001), 116-117.

⁹ Houghton Mifflin Company, "Blue Sky," in *The American Heritage Dictionary of the English Language*, Fourth Edition, 2003.

¹⁰ Houghton Mifflin Company, Scott, David L., "Blue Sky Laws," in *Wall Street Words*, 1997, 1988 ed.



formula or rule of thumb for valuing the *Blue Sky*, the amount of the value that is greater than the value of the tangible assets alone. Such formulas have been published by Glenn Desmond¹¹ and others, and specifically exclude cash, inventory, accounts receivable, and other assets from use in the formula, attempting to ascertain the value of lease and intangible assets only.

How is *Blue Sky* Determined?

The roots of the business valuation industry can be traced to what is sometimes called the *Treasury Method*, a method to estimate the amount and value of *excess earnings* of breweries and distilleries. Excess earnings is the amount earned above the value used to hypothetically *rent* the tangible assets of these businesses.

The excess earnings method¹² was published by the U.S. Treasury Department in “Appeals and Review Memorandum Number 34” (ARM 34) in 1920 (for those of us too young to recall), and was a seminal attempt to quantify the value of intangible assets, then simply thought of as goodwill. The science and art of business valuation has become more sophisticated since that time, including revisions to ARM 34 by Revenue Ruling 68-609 in 1968.

¹¹ Desmond, Glenn, *Handbook of Small Business Valuation Formulas and Rules of Thumb* (Los Angeles, California: Valuation Press, 1994), p. 8.

¹² Pratt, Shannon, *Valuing a Business, The Analysis and Appraisal of Closely Held Companies* (Homewood, Illinois: Business One Irwin, 1989), p. 101.

The excess earnings method has fallen into disgrace in recent years¹³, due to several perceived shortcomings: uncertainty about how to segment the income stream to apply to specific asset categories, and then how to adjust the remaining assets. The Treasury method has been challenged for its inability to identify empirical data for appropriate rates of return on intangible assets, and the method fails to capture growth. Even the Internal Revenue Service has said to use this method only as a last resort, *if no better method can be found*.

SFAS 141 and 142, however, may have revived the Treasury Method. We will ask you to consider using a modified form of the excess earnings method in your company

SFAS 141 / 142

The history of accounting for intangibles is like a circle. The Accounting Principles Board¹⁴ prior to 1970 had considered intangible assets to either possess a limited useful life or an indefinite life. In 1970, however, the APB stated that all intangible assets were essentially depreciating assets, and that no asset should have a useful of longer than 40 years.



With the adoption of SFAS 141 and 142, the accounting rule makers have now returned us to the concept of *definite* and *indefinite* useful life. In fact,

¹³ Pratt, Shannon, *Business Valuation Body of Knowledge, Exam Review and Professional Reference* (New York, New York: John Wiley & Sons, Inc, 1998), pp. 84 - 85.

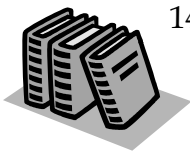
¹⁴ The Accounting Principles Board (APB) was the forerunner to the Financial Accounting Standards Board. In 1970, the APB issued Opinion 16, *Business Combinations*, and Opinion 17, *Intangible Assets*. These accounting rules governed until FASB issued the new standards in 2001.

goodwill, which was previously amortized at most over a 40 year period, is now considered to be an asset with an indeterminate useful life. As such, it is not amortized, but instead it must be tested annually for possible impairment. More importantly, goodwill is no longer the *catch-all* for intangible assets that it has been historically.

According to an interpretation of the revised Generally Accepted Accounting Principles¹⁵:

Under the new standards, greater effort is required to identify all intangibles. Such intangibles cannot expediently be classified as part of goodwill, *as was often done under prior standards ... (emphasis added)*.

SFAS 141 deals with how to report assets on the balance sheet, while SFAS



142 tells accountants how to test for the possible impairment of

indefinite life assets, including goodwill. In your business, you will be most concerned with how the assets are captured and reported on the balance sheet, although you may also be interested in the subtle effects of impairment testing as well.

FASB has adopted these changes to goodwill and intangible asset accounting in reaction to the increased importance of these assets to contemporary business. The public markets demonstrate that for the average public stock the share price reflects \$5 to \$6 dollar of intangible asset value for

¹⁵ Patrick, Epstein, Delaney, et al., *Wiley GAAP 2003, Interpretation and Application of Generally Accepted Accounting Principles* (Hoboken, New Jersey: John Wiley & Sons, Inc, 2002), 446.

every \$1 of tangible asset value! In your business, since it is in technology, it may be that or more.

Under SFAS 141, an acquiring company should now account for the new values (value at the time of the acquisition rather than historical cost) for *all of the target's assets*, including financial assets, tangible assets, and intangible assets (which are separable from goodwill) in order to ascertain the goodwill, which is a *residual value*. The only clearly identified asset that is defined as belonging in goodwill is *assembled workforce*.¹⁶

The remaining goodwill value consists of assets that cannot be specifically identified and valued. Unlike past practices, however, the accountant can no longer conduct a hasty review and then simply put any difference into goodwill (assuming audited financial statements). In addition, once capitalized as goodwill, the company is no longer permitted to automatically amortize the goodwill; rather it must be tested. For this discussion, we treat goodwill as an asset with an indeterminate useful life.¹⁷

The identity and value of the intangible assets other than goodwill must be ascertained, and classified as having either definite or



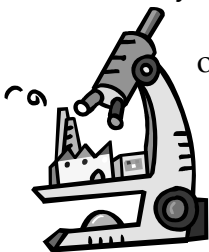
¹⁶ Under Sec. 1060, an assembled work force is considered a Class VI asset, and is therefore not part of goodwill. The reader is cautioned to appreciate the differences in these asset classifications from a GAAP and from a tax application.

¹⁷ Our discussion should not be considered legal or accounting advice, which may set forth different tests for both useful life as well as the asset classifications and the composition of goodwill.

indefinite useful lives. If the purchase price has not been properly allocated, the resulting financial statements will not conform to GAAP. In a 2002 webcast explaining SFAS 141, CPA2Biz explained,

At a minimum, all intangible assets shall be aggregated and presented as a separate line item in the statement of financial position. However, that requirement does not preclude presentation of individual intangible assets or classes of intangible assets as separate line items.... Amortization expense and impairment losses for intangible assets shall be presented in income statement line items within continuing operations as deemed appropriate for each entity.¹⁸

In the *real world*, of course, many companies are not audited or have qualified audits with respect to these asset classifications. (Of course at Olsen Thielen we urge you to obtain an audit or to at least develop a sense of these asset classifications.) This may be especially important, for example, when ascertaining built-in gains when changing from a C corporation tax election to an S corporation tax election.



If you are in the fortunate situation of either buying or selling a company or a division of a company, the information obtained will help in assessing taxes on the transaction or prevent a last minute failure to close. If the deal needs audited financial statements, encourage the parties to begin the asset classification and valuation process as early as possible. This is information for both buyer and seller, so they understand the asset values

¹⁸ Mard, Michael; Hitchner, James, "Implementing SFAS 141: A Practical Case Study of a Business Combination," 2002, webcast presentation for accountants, p. 3,4, Valuation for Financial Reporting, CPA2Biz.

contributing to the negotiated transaction price. This information dispels the negative notion of *Blue Sky*, permitting the parties to visualize what accounts for the difference between book value and the negotiated purchase price.

Advisors have advocated buyers and sellers obtain a company valuation before settling on a transaction price to ensure that the seller is able to achieve a fair selling price and the buyer develop comfort that the price is not too high.¹⁹ Academic and appraisal industry practice literature have contributed to our understanding about how to value an entire business and use that information to evaluate a purchase price. But like past accounting, the aggregate business values obtained for the entire business fail to identify and quantify what comprises the difference between that value and book value.


The classifications proscribed by the new accounting standards provide us with a framework to differentiate and identify the important elements of *Blue Sky*.

¹⁹ Evans, Frank; Bishop, David, *Valuation for M&A, Building Value in Private Companies* (New York, New York: John Wiley & Sons, Inc., 2001). This excellent reference discusses in detail how to conduct and apply valuations of the aggregate firm for mergers and acquisitions and strategic planning.

Purchase Price Allocation

Statement of Financial Accounting Standard 141 (Business Combinations)²⁰ provides excellent discussion about the reasons, conceptual framework, and methods for applying purchase accounting under this standard. In Appendix A of the standard, FASB sets forth definitions of the classifications and then provides examples to clarify what is meant. This will help you identify what intangible assets may exist that you should recognize separately from goodwill.

Contracts

First, you must determine if there is an intangible asset other than  goodwill, according to accounting convention. There is an intangible asset, according to 141, if it arises from "...contractual or other legal rights..."²¹ even if the asset is not transferable or separable from the entity. This would include such assets as lease rights (even though not transferable) or technology patent rights. Thus, if there is a contract that gives rise to value beyond the expenses associated with it (such as a lease that is below fair market rate), that contract may be an intangible asset.

²⁰ Financial Accounting Standards Board, *Financial Accounting Series*, vol. No. S141, *Statement of Financial Accounting Standards No. 141, Business Combinations* (Norwalk, Connecticut: Financial Accounting Foundation, June 2001), pp. 25 - 32.

²¹ *Ibid*, p. 25.

SLERT

What about intangible assets where there is no contract? SFAS requires that if there is no contract, then only those assets that can be considered *separable* or divided from the business should be recognized. This makes intuitive sense, since the other assets that have been traditionally reported are distinct and separate, such as machines, buildings, cash, etc. What does separable mean? The statement says that the asset should be capable of being sold, licensed, exchanged, rented, or transferred to another entity. We have reduced this to an acronym to facilitate remembering it: SLERT. This is our memory crutch for sold, licensed, exchanged, rented, or transferred.

MACCT

After ascertaining that an asset exists, SFAS 141 offers a way to classify it. This classification system is also useful as a checklist to identify the assets. Therefore, determining if the assets are separable and classifying them becomes an interactive process.

In its appendix, SFAS 141 lists five distinct categories:

1. Marketing-related intangible assets such as trademarks and Internet domain names.
2. Artistic-related intangible assets such as literary and musical works.
3. Customer-related intangible assets such as customer lists and order backlogs.



4. Contract-based intangible assets such as licensing, lease, and franchise agreements.
5. Technology-based intangible assets, such as technology (both patented and unpatented) and computer software.

Since these categories or classifications are important, we have reduced them to an acronym: MACCT. This is short for marketing, artistic, customer, contract, and technology.

MACCT and SLERT may not be the best acronyms or memory crutches, but they work for us. Consider a couple examples. Do you have work processes, developed over several years which may your work more efficient? Is it documented and thus transferable? Do you have logos or other artwork which identify your business or products?

The point here is to determine if there are intangible assets that you should recognize separately from goodwill. The following facilitates a view of this decision making:²²

²² Taylor, Herbert; Klein, Timothy; McGookey, Carl; Kurowicki, E.J, "Valuation of Impairment Discussion, What is the affect of SFAS 141 and 142," speech delivered to National Association of Certified Valuation Analysts State Chapter, 2nd Tri-Annual Meeting, Northeast Committee.

		Contractual or Other Legal Right?	
		Yes	No
Separable from Acquired Entity?	Yes	Recognized Separately From Goodwill	Recognized Separately From Goodwill
	No	Recognized Separately From Goodwill	Recognized As Goodwill

Useful Life

The final step in the intangible asset identification process is to determine the useful life of the asset you have classified. Does it have a relatively identifiable useful life wherein it loses value and / or eventually fails to have value? Or is the useful life indeterminate, such that it would seem to hold its value (and perhaps increase in value) into the future.

The FASB implementation reflects a viewpoint that in the past both classification and lifing of assets was less than rigorous. Other tangible and intangible assets with definite useful lives, such as real estate and equipment, will be carried and tested using methods that are similar to the past, although lifing will be more rigorous. The treatment of these assets is now enumerated in SFAS 144, which has replaced SFAS 121.

Life analysis provides an understanding of investment and retirement or decay to gain an appreciation of the life-time characteristics.²³ Tangible assets, like machinery and buildings, possess an economic life, a service life, and a physical life. The economic life is the duration when the asset is profitable; the service life is the time from implementation to retirement, and the physical life is the time from manufacture to eventual destruction, such as through wear and tear.

Intangible assets, of course, don't have a physical life, but they do have both economic and service lives. For our discussion, we will consider the assets' economic life, the time during which it is profitable for the enterprise. Understanding the useful life from an economic standpoint will provide us with an indication of the shape of its amortization over time.²⁴

Under the new rules, intangible assets with indefinite useful lives are no longer amortized, whereas in the past they were amortized over a period not to exceed 40 years. Now these assets are tested at least annually (along with goodwill) for possible impairment under SFAS 142. (Think about what happened to the value of Oldsmobile brand name when it was discontinued.)

²³ Schweihs, Robert; Reilly, Robert, *Valuing Intangible Assets* (New York, New York: McGraw-Hill, 1998), 207.

²⁴ During audits, accountants may also consider whether the useful life of an asset has changed, viz., gone from indeterminate to determinate or changed with respect to the length of time of its useful life.

Goodwill Remainder

After identifying all of the intangible assets using the SFAS 141 procedures and adding them to the value of the financial and tangible assets, you obtain a total value that can now be compared to the company total value determined by your appraiser. In most cases you will still find a difference, i.e. the company value is still larger than the total of all of the identified assets. This difference is goodwill under the new standards.

The only identifiable asset that is specifically included in goodwill is the value of the assembled workforce (except in tax work). It is worthwhile during the asset identification and valuation process to develop an appreciation of the potential value of the assembled workforce as a *reasonableness check*.

After identifying the remaining goodwill balance, the analyst should determine whether that value belongs to the business or to a key person or stockholder.²⁵ Darrell Arne and James Hamill have constructed a five-step purchase price allocation method in conformity with Sec. 1060 of the tax code, with goodwill as the remaining asset. However, these authors observe that this goodwill may be personal and belong to an individual or individuals rather than to the business. By sorting out what goodwill belongs to individuals compared

²⁵ Arne, Darrell; Hamill, James, "Separating Personal and Business Goodwill," *The Tax Adviser, A Magazine of Planning, Trends & Techniques*, June 2003.

to the business can have very large benefits for tax purposes in structuring a transaction.²⁶ It is one more consideration of your possible personal value. .

Using the Tools



Use the summary in SFAS 141 to identify what makes up the difference

between the reported book value and the market value for your

business, the *Blue Sky*. By understanding that difference, you will

better understand the true value.

1. Examine all financial and tangible assets to ascertain that the reported or carried values reflect the present values.²⁷
2. Use the checklist to find possible marketing, artistic, customer, contract, or technology (MACCT) aspects of the company. No values at this point; just list these ideas.
3. Examine your list to see which ones could potentially be sold, licensed, exchanged, rented or transferred. (SLERT)
4. Examine if there is reason to believe that those you have identified and could be sold have a definite useful life. Are they assets that decline in value over time? (Lifing)

²⁶ Adhikari, Mike, "Structuring Deals to Maximize the Seller's After Tax Proceeds" (Las Vegas, Nevada: Business ValueXpress, <http://www.BusinessValueXpress.com>, 2004, verbal).

²⁷ Minnesota Business Valuation Group provides certified real estate and equipment appraisals to comply with this need.

5. Look at the company revenue and income and determine if you can identify and segment what part of the sales or earnings can be directly attributed to the possible asset that you've listed.
6. Goodwill is the remainder value, the amount that the company value still exceeds the sum total of the identified assets. Examine this goodwill remainder to determine what value belongs to the business and if any values should appropriately be designated for an individual or group of persons.
7. Examine the rough allocations that you have made with respect to tax implications for the buyer and seller.

Developing the list to this point helps to begin to understand the underlying intangible value drivers in your company. But the list is without context; it doesn't give a visual reference of how these listed items relate to value.

The best visual reference we have seen to date has been illustrated by a visual chart used by the Financial Valuation Group.²⁸ This model is often used by Michael Mard and James Hitchner, who we referred to earlier in our reference to CPA2Biz. Mard and Hitchner, along with two other contributors, have written seminal materials on both SFAS 141 and 142 for the valuation industry.²⁹

²⁸ [online] Financial Valuation Group, <<http://www.FairMarketValue.com>>.

²⁹ Hitchner, Mard, et al., *Valuation for Financial Reporting, Intangible Assets, Goodwill, and Impairment Analysis, SFAS 141 and 142* (New York, New York: John Wiley & Sons, Inc, 2002), p. 42.

Mard and Hitchner suggest modeling by developing a chart of parallel values of assets in one column and liabilities and equity in another, much like a balance sheet. Because both columns must be equal, we know that increasing the asset column means the liability / equity column must also increase proportionally. Thus, begin by listing the assets that have been disclosed by the accounting, and then begin to add the other assets you have potentially identified.

Example Software Company

Imagine you work at Example Software Company. The company has retained an appraiser who has provided you with a valuation of the business with a suggested fair value equity value of \$1,000,000. You have a copy of the current financial statements.

The following is the example company's current balance sheet.

EXAMPLE SOFTWARE COMPANY
Balance Sheet

Cash & Equivalent	50,000	Current Long Term Debt	25,000
Accounts Receivable	250,000	Accounts Payable	75,000
Pre-paid Taxes	25,000	Accrued Taxes	10,000
		Wages, Rent, etc.	15,000
Current Assets	325,000	Current Liabilities	125,000
Real Estate	300,000	Bank Loan	300,000
FF&E	75,000	Leases	100,000
Intangibles		Long Term Liabilities	400,000
Marketing	0	Total Liabilities	525,000
Artistic	0	Paid-in Capital	50,000
Contract	0	Retained Earnings	125,000
Customer	0	Total Equity	175,000
Technology	0		
Long Term Assets	375,000		
Goodwill	0		
Total Assets	\$ 700,000	Total Liability & Equity	\$ 700,000

The zero balances for the intangible assets and goodwill would not be displayed as we have done, of course. We include them so that you can start thinking about how you are going to explain a value of \$1.0 million for the company equity compared to \$175,000 in reported value!

For the first part of the answer to this question, we will look at the company's hypothetical income statement. We have constructed a hypothetical one to illustrate the last 12 months.

EXAMPLE SOFTWARE COMPANY
Income Statement

Sales	2,000,000
Cost of Sales	400,000
Gross Profit	1,600,000
R&D	250,000
Sales - Marketing	400,000
Administration	
Personnel	600,000
Supplies, Phone, etc	25,000
Other Expenses	
Interest	40,000
Miscellaneous	5,000
Total Expenses	1,320,000
Profit Before Taxes	280,000
Income Tax	112,000
Profit After Tax	\$ 168,000

This certainly explains why the business has a value well in excess of stockholders' equity. The after tax profit is nearly as large as the reported equity, thus offering a near 100% return on equity! While these are not the financial statements for an actual company, we have worked with companies with similar profiles.

The valuation report that you receive will usually provide you with only the total value of the company. However, the valuation report should (see the Uniform Standards of Professional Appraisal Practice³⁰ and other appraisal

³⁰ The Appraisal Standards Board (ASB) of the Appraisal Foundation develops, publishes, interprets, and amends USPAP on behalf of appraisers and users of appraisal services. The Appraisal Foundation was formed in response to the failure of many savings and loan institutions, due to poor real estate appraisals. More information is available at <http://www.AppraisalFoundation.org>. Other relevant standards include those formulated by

industry standards) offer sufficient explanation of how the total value was determined so that you are able to *replicate* the findings. Typically, the appraiser will detail methods for the income approach and the market approach for a going concern, but will often by-pass the asset approach because the intangible assets are not valued separately. Knowing what you now do about SFAS 141, however, you would prefer that the appraiser also value the separate asset categories. In the absence of that work, your task is to ascertain what the gap between book value and fair market value is.

For this abbreviated exercise we will begin by converting the reported balance sheet into a box diagram, such as suggested by the Financial Valuation Group. By using the diagram, the user is able to get away from the look of accounting and instead provide a more visual feel for the client.

VALUE BOX																							
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<table border="1" style="width: 100%;"> <tr> <td>Intangibles</td> <td></td> </tr> <tr> <td> Marketing</td> <td style="text-align: right;">0</td> </tr> <tr> <td> Artistic</td> <td style="text-align: right;">0</td> </tr> <tr> <td> Contract</td> <td style="text-align: right;">0</td> </tr> <tr> <td> Customer</td> <td style="text-align: right;">0</td> </tr> <tr> <td> Technology</td> <td style="text-align: right;">0</td> </tr> <tr> <td>Long Term Assets</td> <td style="text-align: right;">375,000</td> </tr> <tr> <td>Goodwill</td> <td style="text-align: right;">0</td> </tr> </table>	Intangibles		Marketing	0	Artistic	0	Contract	0	Customer	0	Technology	0	Long Term Assets	375,000	Goodwill	0	<table border="1" style="width: 100%;"> <tr> <td>Paid-in Capital</td> <td style="text-align: right;">50,000</td> </tr> <tr> <td>Retained Earnings</td> <td style="text-align: right;">125,000</td> </tr> <tr> <td>Total Equity</td> <td style="text-align: right;">175,000</td> </tr> </table>	Paid-in Capital	50,000	Retained Earnings	125,000	Total Equity	175,000
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the American Society of Appraisers, the National Association of Certified Valuation Analysts, the Association for Investment and Management Research, and the Institute of Business Appraisers.

For our purpose, we don't need the detail, even limited to the selected financial highlights in these statements. Therefore, we will consolidate the totals.

VALUE BOX	
Financial Assets 325,000	Financial Liabilities 125,000
Tangible Assets 375,000	Long Term Liabilities 400,000
Intangibles	Total Equity 175,000
Marketing 0	
Artistic 0	
Contract 0	
Customer 0	
Technology 0	
Goodwill 0	
Total Assets \$ 700,000	Total Liability & Equity \$ 700,000

The current assets and current liabilities do not provide much information for this exercise, since we will assume that the working capital is equal to fair value.³¹ Therefore, we simply net these two to display net working capital as the financial asset. This reduces the totals from \$700,000 to \$575,000 and allows a simpler model.

³¹ SFAS 141 and 142 use Fair Value and not Fair Market Value.

VALUE BOX			
Net Financial Assets	200,000	Long Term Liabilities	400,000
Tangible Assets	375,000		
Intangibles			
Marketing	0		
Artistic	0		
Contract	0		
Customer	0		
Technology	0		
Goodwill	0	Total Equity	175,000
Total	\$ 575,000	Total	\$ 575,000

The first step in the actual allocation will be to determine the current value of the tangible assets (real estate and FF&E), but for this purpose we will assume that the values are as reported. We next highlight only the remaining assets: the intangible assets, including goodwill, and stockholders' equity.

We know that the appraiser has said that fair market value of the equity of the enterprise is \$1.0 million, and we have financial statements that indicate book value is \$175,000. The difference of \$825,000 is either represented by an increase in the reported assets (such as an increase in the value of real estate or equipment) or by an increase in intangible assets (including goodwill).

VALUE BOX			
Net Financial Assets	200,000	Long Term Liabilities	400,000
Tangible Assets	375,000		
Intangibles			
Marketing	?		
Artistic	?		
Contract	?		
Customer	?		
Technology	?		
Goodwill	?	Reported Equity	175,000
Total Intangibles	825,000	Premium on Purchase	825,000
Total	\$ 1,400,000	Total	\$ 1,400,000

This box diagram is helpful, keeping you focused on the ultimate total company value, enumerating the explanatory difference to reported book value.

This exercise comprises the preliminary steps an appraiser uses to identify and then value the discreet intangible assets in your business for purchase price allocation. It is beyond the scope of this presentation to describe exactly how each of these assets is valued, but if you compare the checklist of intangible assets that you have identified to the income statement we displayed earlier, you should begin to develop an understanding of how much of the sales or earnings may be contributed by each of the identified assets. We refer you to SFAS 141 to review the examples that FASB has set forth.

SFAS Examples of Intangible Assets

		Contractual	Separable
a. Marketing-Related			
(1)	Trademarks, tradenames	X	
	Service marks, collective marks,		
(2)	certification marks	X	
	Trade dress, (unique color, shape, or		
(3)	package design)	X	
(4)	Newspaper mastheads	X	
(5)	Internet domain names	X	
(6)	Noncompetition agreements	X	
b. Customer-Related			
(1)	Customer Lists		X
(2)	Order or production backlog	X	
(3)	Customer contracts and relationships	X	
(4)	Noncontractual customer relationships		X
c. Artistic-Related			
(1)	Plays, operas, ballets	X	
	Books, magazines, newspapers, other		
(2)	literary	X	
	Musical works: compositions, song lyrics,		
(3)	advertising jingles	X	
(4)	Pictures, photographs	X	
(5)	Video & audiovisual	X	
d. Contract-based			
(1)	Licensing, royalty, standstill agreements	X	
	Advertising, construction, management,		
(2)	service, supply	X	
(3)	Leases	X	
(4)	Construction permits	X	
(5)	Franchise agreements	X	
(6)	Operating / broadcast rights	X	
	Use rights: drilling, water, air, mineral,		
(7)	timber, cutting, route	X	
(8)	Service, such as mortgage servicing	X	
(9)	Employment contracts	X	
e. Technology-based			
(1)	Patents	X	
(2)	Software and mask works	X	
(3)	Unpatented technology		X
(4)	Databases, including title plants		X
	Trade secrets: secret formulas, processes,		
(5)	recipes	X	

If you then examine the expected useful life and estimate an annual amortization of the assets you've identified, you will get a sense of how much the asset is really contributing to the overall value of the company, and how much annual reinvestment it may take to maintain the asset. This information should be critical to assist you in explaining the value of your company.

Finally, add all of the financial, tangible, and identified intangible assets together, and subtract this from the aggregate company value. The remaining difference is goodwill or *Blue Sky* under the new definitions. Then remember to ascertain whether this is business or individual goodwill. The following identification of assets and allocation offers an example of what this could look like.³²

VALUE BOX			
Net Financial Assets	200,000	Long Term Liabilities	400,000
Tangible Assets	375,000		
Intangibles			
Marketing	100,000		
Artistic	75,000		
Contract	125,000		
Customer	225,000		
Technology	275,000		
Goodwill	25,000		
Total Intangibles	825,000	Reported Equity	175,000
		Premium on Purchase	825,000
Total	\$ 1,400,000	Total	\$ 1,400,000

Importantly, you have now reduced the *Blue Sky* or unexplained portion of the \$825,000 difference in value between the book value and the transaction price to \$25,000. After explaining the value of the assembled workforce, you can see how easy it is to explain the premium to book value. (I don't mean with precision, but rather in general terms.) Depending on your position within the company, you may now wish to see in which classification you fit and how you contribute value.

³² Contact us for questions about valuing specific assets.
[Http://www.BusValGroup.com](http://www.BusValGroup.com).

Goodwill Impairment

Although our discussion has focused on understanding the intent of SFAS 141 with respect to identifying intangible assets, SFAS 141 was adopted by FASB in connection with SFAS 142. This is the standard that now instructs accountants how to treat assets with indefinite useful lives, assets like goodwill.

For the past 30 years, the accounting standards have required amortization of intangible assets over a period of not longer than 40 years. During a review of this procedure, however, FASB learned that financial statement users had little confidence in the validity of amortization expense, and that they considered the amount of goodwill as an asset.³³ Those surveyed believed that goodwill may actually increase in value, and an arbitrary annual amortization does not necessarily accurately reflect the correct decrease in value, if any.

Since FASB no longer permits automatic amortization of goodwill (or other indefinite life assets), the accounting standards now require instead that companies test – at least annually – those indefinite life assets for possible impairment. This means that the auditor should be assured that the asset reported on the balance sheet has not declined in value during the intervening period.

³³ Mercer Capital, *Valuation for Impairment Testing, The Finance and Accounting Professional's Guide to Valuing Reporting Units for Compliance with SFAS 142* (Memphis, Tennessee: Peabody Publishing LP, 2001), 3.

The testing for impairment is beyond the scope of this presentation, but the auditor has a choice of two tests: Step 1 testing to ascertain if goodwill has been potentially impaired, and Step 2, wherein the appraiser must do a full analysis (SFAS 141 purchase price allocation) to determine the value of the residual asset, goodwill.³⁴ In practical terms, if the fair value of a company's equity³⁵ is greater than its reported book value, then a Step 1 test would suggest that the more detailed Step 2 testing is not required.

Conclusion

During the presentation, we learned how the term *Blue Sky* differs today from its historical meaning, and how the accounting industry now requires certain companies to provide more detail on the kind of intangible assets it has. We learned that because of these accounting standards, buyers who expect to have audited financial statements must now comply with SFAS 141 and delineate these asset classifications.

While it is beyond the scope of our presentation to detail how to value these discrete assets, we learned how to identify potential assets, and we explained where they would be reported on the financial statements. We also discussed how assets with an indeterminate life must be tested annually for

³⁴ Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets* (Norwalk, Connecticut: Financial Accounting Standards Board, 2001), 1.

³⁵ Some accountants use the total value of the assets rather than equity.

possible impairment, and how to examine the useful life of determinate life assets.

Today you learned enough to increase your knowledge of your company and new things your accountant may ask for. With this knowledge you have increased your ability to see the 'big picture' and hopefully where you may fit. Almost all of this intangible asset creation has been obtained at company expense. But we've seen that while expensed, these costs may have increased company value even while giving the owners a tax shield.³⁶

Take Away

1. Blue Sky = Difference between book value and market value.
2. Intangible Assets plus Goodwill = Blue Sky
3. MACCT = Marketing, Artistic, Customer, Contracts, Technology
4. SLERT = Sell, License, Exchange, Rent, Transfer
5. Indefinite or defined Useful Life
6. SFAS 141 - Purchase price allocation

With this information you are armed to better assess your real firm value and your contribution to it and perhaps ways to improve it and / or communicate that to others in the company.

³⁶ The author thanks the following persons for kindly spending the time and effort to review drafts of this paper: Bill Reddington, Reddington Business Valuation; Rand Curtiss, Loveman-Curtiss, Inc.; Ron Bruzek, Minnesota Business Valuation Group; Marcie Bour, Marcie Bour, CPA; Darrell Arne, Exit Strategies, LLC; Darren Cordier, Bernstein, Conklin and Balcombe; and Mike Adhikari, BusinessValueXpress. Of course, all mistakes that remain are solely the responsibility of Randall K. Schostag.

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