

Mergers & Acquisitions

—A snapshot

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Acquired assets not intended to be used: You may need to record them, even if you don't use them!*

In many M&A transactions, a buyer may acquire assets it does not intend to use. Prior to the M&A Standards¹, buyers generally would assign little or no value to assets that are not intended to be used when accounting for an M&A transaction. Now, such assets are required to be recognized at fair value from a market participant perspective, even if that perspective differs from that of the actual buyer. As a result, buyers will need to consider how others might use these assets, as well as how these assets might benefit other assets acquired, or those they already own.

One common type of asset that a buyer does not intend to actively use that is receiving considerable attention is called a "defensive asset." This volume of *Mergers & Acquisitions - A snapshot*, focuses on some of the issues companies may face when initially recognizing, measuring and subsequently accounting for defensive assets.

¹ Accounting Standards Codification 805 (which incorporates FAS 141(R), Business Combinations), is the US Standard on M&A, and Accounting Standards Codification 810 (which incorporates FAS 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment to ARB No. 51), is the US Standard on consolidations (collectively the "M&A Standards").

What is a defensive asset?

A defensive asset is an asset that a buyer does not intend to actively use, but intends to prevent others from using by withholding the asset from the marketplace. This is done to prevent competition, or to enhance the value of an existing asset. A common example of a defensive asset is an acquired brand that an entity may plan to use for a transition period, before re-branding the product to its own brand. The buyer then "locks up" the acquired brand and will not make it available for others to use. In this way, the buyer removes a competitor and hopes to increase its own market share. Previously, the fair value of an acquired brand was determined taking into consideration only the buyer's intentions. Little or no value would typically have been assigned to that brand because the buyer did not intend to actively use the brand beyond a transition period. Now, the fair value of this asset is determined taking into consideration how market participants would use the asset. As a result, the fair value assigned to the brand will likely be higher.

The previous and current treatment in determining the fair value of defensive assets is summarized below:

Previous Treatment	Current Treatment
<ul style="list-style-type: none"> • Buyer's intentions influence value • For assets withheld from the market or employed transitionally, generally little or no value was typically assigned 	<ul style="list-style-type: none"> • Buyer's intentions do not influence value. Assets are measured using market participant assumptions • Buyers will need to consider the direct and indirect incremental cash flows created by withholding the asset from the marketplace in ascribing value and determining the economic life of the asset

As a result of these changes more defensive assets will be recognized than under previous practice and at higher values. Future earnings will also be impacted as the assets are amortized or impaired in subsequent periods.

While brands are examples of defensive assets, other examples include trade names, technologies, franchise rights, and licenses. The following table outlines the two

main categories of defensive assets and general observations related to each.

Categories	Observations
<ul style="list-style-type: none"> • Buyer <i>does not</i> actively use the asset, but a market participant would (e.g., brands, licenses) 	<ul style="list-style-type: none"> • Typically of greater value relative to other defensive assets • Common example: Industry leader acquires significant competitor and does not use target brand
<ul style="list-style-type: none"> • Buyer <i>does not</i> actively use the asset, <i>nor</i> would a market participant (e.g., process technology, know-how) 	<ul style="list-style-type: none"> • Typically smaller value relative to other defensive assets • Common example: Manufacturing process technology or know-how that is well known within the industry, but still withheld from the market to prevent new entrants into the market

Initial measurement of defensive assets

A buyer's determination of how a market participant would use an asset will have a direct impact on the initial value ascribed to each defensive asset. Therefore, identifying market participants, developing market participant assumptions and determining the appropriate valuation basis are critical components in developing the initial fair value measurement for defensive assets. At a minimum, these considerations would include the following:

Unit of accounting - All defensive assets should be recognized and valued separately. They should not be combined with other assets even if the purpose of acquiring the defensive asset is to enhance the value of those other assets.

Defining market participants - Determining who the market participant is will be important in deriving the appropriate cash flows used to value the asset. Additionally, market participants may be defined differently for a given defensive asset within the transaction versus a market participant for the transaction as a whole.

Valuation techniques and approaches - For defensive assets, common valuation techniques will likely still apply (e.g., relief from royalty, with-and-without), taking into account the cash flows realizable by a market participant. However, while the valuation techniques may be consistent with prior practice, the need to use market participant assumptions and hypothetical cash flow forecasts will require more effort. For example, determining the hypothetical cash flows that a market participant would generate if it were to use the defensive asset in the marketplace will require a significant amount of judgment.

When determining the fair value of a defensive asset, it may also be appropriate to estimate the direct and indirect benefits associated with the defensive use of the asset. Accordingly, models may need to be refined to appropriately capture the value associated with locking up the acquired asset. That value may be attributed to enhancements to other complementary assets, such as an existing brand, increased projected profit margins from reduced competition, or avoidance of margin erosion from a competitor using the brand that the buyer has locked up.

Regardless of the methodology used in valuing the defensive asset, it is important not to include value in a defensive asset that is already included in the value of another asset.

Determining the useful life for a defensive asset

A buyer should consider its expected use of a defensive asset when determining the asset's useful life and amortization method. This is different from the market participant assumptions used to determine the fair value of a defensive asset at the acquisition date. That is, the useful life and pattern of amortization will be buyer-specific. However, the useful life of a defensive asset should not be limited simply to the short transition period, if any, that the buyer will actively use the asset. It should also consider the period that the buyer's other assets will generate incremental cash flows as a result of acquiring the defensive asset.

Defensive assets should not be immediately written off, but are expected to diminish in value over time due to the lack of support provided to the asset (e.g., lack of selling and marketing efforts to maintain a brand). Classification of a defensive asset as an indefinite-lived asset will be rare. For example, a buyer may acquire a brand that it intends to use defensively. While the target may have considered the brand to be indefinite-lived, the lack of selling and marketing efforts by the buyer to maintain the brand will likely cause the value of the brand to deteriorate over time. Therefore, the defensive asset would likely have a finite life, even if the cash flows used to value the

asset extend for a long period of time. Further, the amortization method used should reflect the pattern in which the fair value of the defensive asset diminishes over time.

The following table presents general observations of useful lives related to defensive assets:

Categories	Useful Life
<ul style="list-style-type: none"> Buyer <i>does not</i> actively use the asset, but a market participant would (e.g., brands, licenses) 	<ul style="list-style-type: none"> Likely longer in term
<ul style="list-style-type: none"> Buyer <i>does not</i> actively use the asset, <i>nor</i> would a market participant (e.g., process technology, know-how) 	<ul style="list-style-type: none"> Likely shorter in term

Subsequent measurement of defensive assets

In most cases, the subsequent measurement of defensive assets will follow the same approach as all other finite-lived assets. That is, these assets will be tested for impairment if events or changes in circumstances (triggering events) indicate that the assets' carrying amount may not be recoverable. This determination should be made at the lowest level of independent cash flows, which likely will include a group of other assets that may shield an individual defensive asset from impairment. If a triggering event never occurs it is possible that defensive assets may never be tested for impairment.

If an impairment is required, the defensive asset's fair value will be based on market participant assumptions at that time and not buyer specific assumptions.

Not all unused assets are defensive assets

An acquired asset that a buyer does not intend to actively use and does **not** intend to prevent others from using is **not** a defensive asset. An example could be a customized software program internally developed by the target that the buyer, similar to other market participants, only plans to use for a short transition period until the target company is successfully transitioned to the buyer's existing software system. The buyer's initial measurement of the customized software program is based on it likely having limited value and a short economic life, since the acquired

asset will only generate value to the buyer and to market participants over the transitional period. This type of an acquired asset would not be considered a defensive asset. The M&A standards did not change practice for these types of assets.

Conclusion

The M&A standards have created a significant change in the accounting for defensive assets acquired in an acquisition, leading to more finite-lived intangible assets and less goodwill. In most circumstances, new approaches will be required to assess the fair value of defensive assets. In some cases, creation of hypothetical cash flows will be required to assess market participant perspectives. Bottom line? Identifying and estimating the fair value of defensive assets will require greater consideration than in the past. Remember, if an asset has value to someone, then it likely has value to you.

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- *Mergers & Acquisitions*—A snapshot—a series of publications for senior executives and deal makers on emerging M&A financial reporting issues
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- *A Global Guide to Accounting for Business Combinations and Noncontrolling Interests: Application of U.S. GAAP and IFRS Standards*—for accounting professionals and deal makers
- *DataLine 2008–01: FAS 141(R), Business Combinations*—for accounting professionals and deal makers
- *DataLine 2008–02: FAS 160, Noncontrolling Interests in Consolidated Financial Statements*—for accounting professionals and deal makers
- *DataLine 2008–27: FASB Proposed Amendments To The Accounting For Acquired Contingencies under FAS 141(R)* —for accounting professionals and deal makers
- *DataLine 2008–30: Key Considerations for Implementing FAS 141(R) and FAS 160*—for accounting professionals and deal makers
- *DataLine 2008–35: Nonfinancial Asset Impairment Considerations*—for accounting professionals and deal makers
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