ARE MY EMPLOYEES INTANGIBLE ASSETS?

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Most companies would agree that their employees contribute significant value to their business. This value is derived from the specialty skills and abilities their employees contribute, or intellectual capital, and the availability of an assembled workforce that is prepared to continue operations of the business from day one after a business combination. An employee's intellectual capital is valuable due to their special know-how that can set a business apart from the competition. An assembled workforce is valuable in an acquisition because it saves the acquiror from costs related to recreating the existing workforce, such as the costs associated with recruiting, training a similar workforce, and lost productivity during the assemblage process. If employees contribute value to a company, can they be considered intangible assets in a business combination scenario?

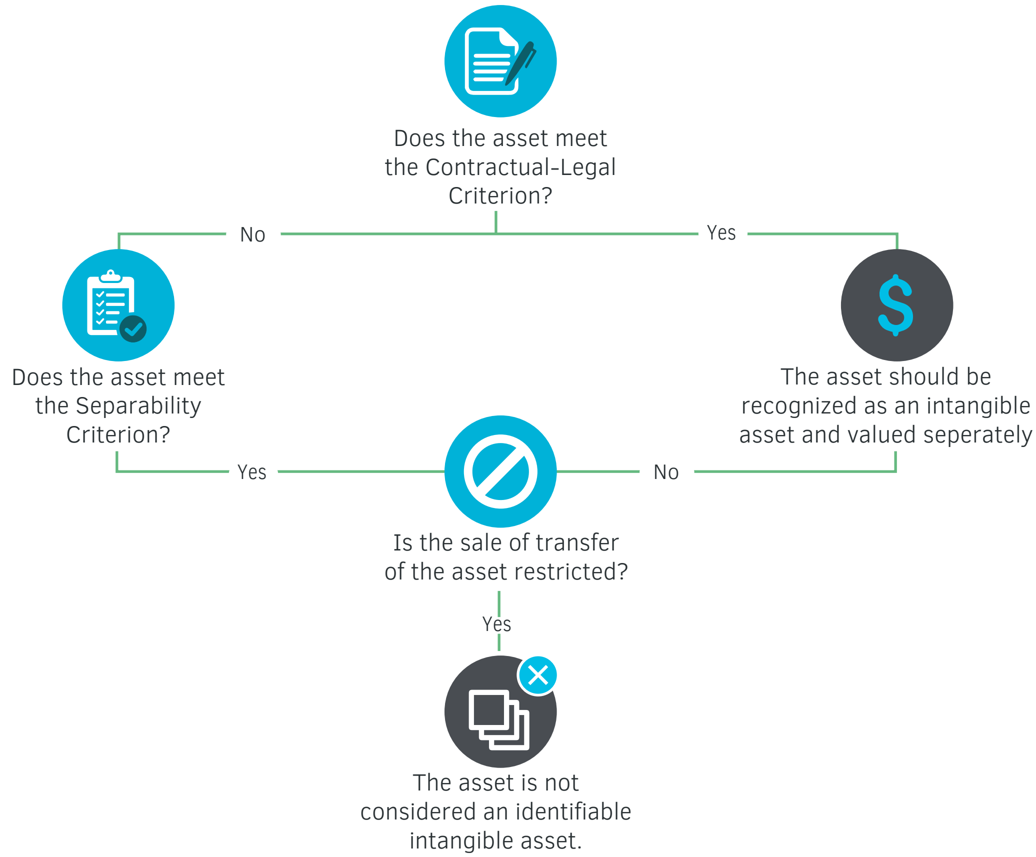
DETERMINING INTANGIBLE ASSETS?

The Financial Accounting Standards Board (FASB" Accounting Standards Codification (ASC) Topic 805, Business Combinations, provides valuation professionals with criteria to determine whether an asset can be recognized as a separately identifiable intangible asset in a business combination in the context of performing a purchase price allocation (PPA). Based on ASC 805-20-55-2 through 55-3, the two determining criteria are as follows:

01 Contractual-Legal Criterion: The intangible asset arises from contractual or legal rights, even if those rights are not separable or transferable.

02 Separability Criterion: The intangible asset can be separated from the acquiree and can be reasonably transferred, sold, licensed, rented, or exchanged without any restrictions on the transferability of the asset (e.g., confidentiality agreements).

Acquired intangible assets that meet either of the above criteria are accepted as identifiable assets that are recognized separately from goodwill and measured at fair value at the acquisition date. However, if the acquired intangible assets do not meet either of the above criteria, then the value of the intangible assets will be subsumed into goodwill. The thought process of determining identifiable intangible assets is as follows:



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ASSEMBLED WORKFORCE VS INTELLECTUAL CAPITAL AS INTANGIBLE ASSETS

Intellectual capital and assembled workforces are accounted for differently in a business combination, and while some types of value are attributable to identifiable intangible assets, others are not.

Under ASC 805, an assembled workforce is not considered an identifiable intangible asset because it does not meet either the contractual-legal criterion or the separability criterion. The contractual-legal obligation is not met because although some or all of the individual employees have a contract to work with the company, the workforce as a whole does not have a single contract that would be eligible to meet the contractual-legal criterion. The separability criterion is not met because an assembled workforce cannot be reasonably separated and transferred from one company to another without disturbance of the daily operations of the acquiree's business.

Although an assembled workforce cannot be considered an intangible asset, the value of the intellectual capital derived from specialized knowledge and experience that employees of an acquiree bring to their jobs may be captured in the value of other intangible assets in certain circumstances. A noncompete agreement is an identifiable intangible asset that is associated with employment and arises from legal or contractual rights to meet the contractual-legal criterion. An acquiree may have preexisting noncompete agreements at the time of the acquisition. These agreements are considered valuable because they prohibit certain employees with special skills or knowledge of the business from competing with the acquiree for a certain period of time as defined by the agreement. These agreements protect the use of that employee's intellectual capital. Intellectual capital is also indirectly accounted for in the valuation of certain intangible assets, such as proprietary technologies and processes, because the intellectual capital of the employees that created those assets is embedded in their value.

VALUING ASSEMBLED WORKFORCE

When to value?

Although an assembled workforce is not valued as an identifiable intangible asset when performing a PPA, the workforce must be valued when using a multi-period excess earning method (MPEEM) in valuing the primary asset acquired in a business combination. When using an MPEEM, the primary asset is valued by isolating the cash flows attributable to that asset over its remaining useful life and then discounting those incremental after-tax cash flows at an appropriate discount rate. As the primary asset generates cash flows, certain tangible and intangible assets (e.g., networking capital, fixed assets, assembled workforce) contribute to the realization of those cash flows and must be separated out to find the residual or excess earnings attributable to the primary asset. In order to isolate the cash flows, contributory asset charges for each of the contributing assets must be calculated and removed from the cash flows. An assembled workforce represents one of these contributing assets and therefore must be valued when performing an MPEEM.

How to value?

Generally, the assembled workforce is valued using a cost approach. Specifically, the form of the cost approach used by many valuation professionals to value the assembled workforce is called the replacement cost new less depreciation (RCNLD) method. The objective when using the RCNLD method is to approximate the cost to reconstruct an asset of similar utility. This approach considers all of the costs that an acquiror would incur to replace the current assembled workforce with a new but comparable assembled workforce. The method considers the following four cost components: direct costs (i.e., compensation and benefit expenses), indirect costs (i.e., recruiting, interviewing, and training expenses), developer's profit, and entrepreneurial incentive. Developer's profit represents the expected rate of return or theoretical market participant profit margin that would be earned on the investment (direct plus indirect costs) as related to the recreation efforts of an assembled workforce. Entrepreneurial incentive is effectively the opportunity cost or lost income during the recreation period of choosing to build an assembled workforce as opposed to investing in an alternative asset.

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RCNLD Example

To value an assembled workforce, consider the following simplified example: an assembled workforce consists of a CEO, a senior engineer, and an entry-level developer. The first step to value this assembled workforce would be to calculate the direct and indirect costs associated with each of the different levels of employees contained in the assembled workforce. Examples of direct costs include the average base salary per employee, variable incentive, benefits, and payroll taxes. Examples of indirect costs include recruiting, interviewing, training expenses, starting efficiency of each new employee, and the time it would take for each new employee to reach full productivity. These costs together represent the direct and indirect costs incurred when recreating the workforce. Subsequently, a developer's profit and entrepreneurial incentive are included to conclude on the fair value of the assembled workforce. Below we have provided an example of this calculation.

Replacement Cost New Less Depreciation In $000s	Direct Costs	Indirect Costs		
	Total Compensation [1]	Recruiting and Training Costs [2]	Avoided Productivity Costs [3]	Total Replacement Cost New
CEO	$518	$60	$97	$157
Senior Engineer	$158	$9	$13	$22
Entry Level Developer	$82	$3	$2	$5
	Total Direct and Indirect Costs		5.0%	$184
	Developer's Profit [4]			$10
	Total Costs (including developer's profit)			**$194**
	Estimated Total Replacement Period (Months)		6	
	Estimated Average Replacement Cost Over Term		$97	
	Required Return on Investment (Monthly)		1.3%	
	Required Return Adjusted for Replacement Period		7.5%	
	Entrepreneurial Incentive [5]			$7
	Fair Value of Assembled Workforce			**$201**

Footnotes:

[1] The total compensation for each employee consists of a base salary, variable incentive which ranges from 10.0% to 50.0%, benefits of 10.0%, and payroll taxes of 5.0%.

[2] Recruiting and training costs range from 5.0% to 20.0% of base salary depending on seniority.

[3] Avoided productivity costs are estimated based on starting efficiency ranging from 25.0% to 50.0% and months to full productivity ranging from 1 to 6 months depending on seniority.

[4] Developer's profit can be approximated from comparable market participant EBIT margins in a target company's respective industry. We assumed an EBIT margin of 5.0%. Developer's profit is calculated as follows: (Total Direct and Indirect Costs / (1 - Profit Margin)* Profit Margin)

[5] Entrepreneurial incentive is calculated based on the following assumptions: estimated replacement period of assembled workforce of 6 months, required return on investment is based on the weighted average cost of capital ("WACC") of the target company which is calculated based on comparable market participant company data in the target company's respective industry. We utilized an assumption of 15.0% adjusted to a monthly rate.

CONCLUSION

Employees attribute a significant amount of value to a company, whether in the form of intellectual capital or as an assembled workforce. In an ASC 805 analysis, the value of an assembled workforce is attributed to goodwill because the contractual-legal and separability criteria are not met; however, an assembled workforce must be valued when contributing to the cash flows of an asset that is being valued with an MPEEM. Although an assembled workforce cannot be treated as a separately identifiable intangible asset according to ASC 805, the value of an employee's intellectual capital may be embedded in the value of other intangible assets.

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