

BUSINESS VALUATION

SPORTS FRANCHISE ACQUISITIONS: PURCHASE PRICE ALLOCATION PROCEDURES. PART 1 OF 2

By Robert F. Reilly

The sale and purchase of professional sports franchises generally receives a lot of welcome publicity and media attention—as well as some unwanted attention from the IRS and other taxing authorities. A professional sports franchise purchase price allocation is a challenging valuation analysis, particularly with regard to the valuation of acquired intangible assets. Economic justification of the prices paid for professional sports franchises—based on traditional pricing metrics, such as price/earnings multiples—is often difficult because many sports franchises do not generate positive accounting earnings.

Part One of this two-part article considers why both fans and taxing authorities seem to be obsessed with sports franchise transactions. It then summarizes both the financial accounting and income tax accounting rules with regard to sports franchise purchase price allocations, and describes many of the relevant intangible assets.

Part Two will explore the most common procedures analysts use to identify, value, and “life” these transferred, intangible assets, then illustrate a purchase price allocation of a hypothetical sports franchise transaction. It will describe how the national franchise agreement is sometimes valued by the capitalization of “residual income” over the current franchise term and any expected franchise renewals. This residual income is the franchisee’s expected income after the discrete intangible asset income has been allocated to those intangibles. Part Two will also illustrate a typical sports franchise purchase price allocation.

Sports franchise transactions and owners. Professional sports franchise sales receive so much attention for several reasons. A transaction typically involves the purchase of a sports team and its player contracts. Franchise and team purchases sometimes result in team roster changes, player contract terminations, player trades, coach reassign-

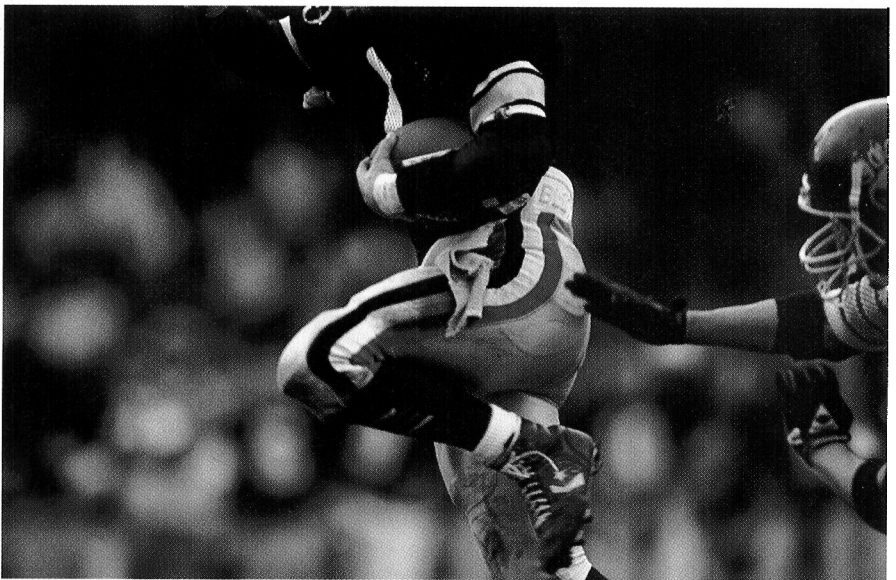
ments, and other organizational disturbances that interest fans. Furthermore, both the success and the ownership of a professional sports franchise are matters of citywide and regional pride.

Outspoken and opinionated franchise owners are often as newsworthy as the team’s star players, and sports franchise transactions can involve multi-hundred-million-dollar price tags. These transactions are usually reported in both the general business news media and the sports news media.

stadium for ad valorem property tax purposes. While the IRS often concludes that the franchise purchase price is principally related to nonamortizable franchise value, local taxing officials often conclude that the same purchase price relates principally to the stadium’s leased fee interest or leasehold interest.

Financial Accounting

Virtually all professional sports franchises are closely held businesses and do not publicly report their financial state-



Taxing Authority Interest

The IRS pays particular attention to franchise purchase transactions. Compared to the typical closely held business sale, professional sports franchise sales involve fairly large prices and taxable gains or losses. In addition, sports franchise buyers are typically wealthy individuals with substantial business interests and a high public profile.

With regard to transaction purchase price allocations, sports franchises are generally subject to different basis/amortization tax rules than most other businesses. Sports franchises also have relatively unique intangible assets, which often require a very special application of valuation approaches and methods. Accordingly, sports franchise purchase price allocations often attract the attention of the IRS.

State and local taxing authorities are also interested in sports franchise sales. These transactions may provide the justification for a revaluation of the franchise’s

ments. Accordingly, buyers and owners are not concerned with purchase price allocation for financial reporting purposes. Many franchises, however, have minority owners that receive periodic financial statements, and even single-owner franchises typically prepare financial statements in compliance with GAAP.

SFAS 141 and 142 provide GAAP guidance with regard to purchase price allocation accounting. SFAS 141, *Business Combinations*, provides that all business combinations be accounted for using the purchase method of accounting. SFAS 142, *Goodwill and Other Intangible Assets*, provides guidance related to the capitalization and amortization of acquired intangible assets in business combinations. For goodwill and other intangibles recorded prior to SFAS 141, SFAS 142 allows the impairment loss related to previously purchased goodwill and intangibles to be recognized as the effect of a change in accounting principle. The first *Sidebar*

Editor:

Martin J. Lieberman, ASA, CPA/ABV

SFAS 141 AND 142

The following excerpts from SFAS 141 and 142 provide GAAP guidance to the purchase price allocation of a sports franchise.

SFAS 141, Business Combinations

Paragraph 10, definition of a business combination: "This Statement applies to combinations involving either incorporated or unincorporated entities. The provisions of this Statement apply equally to a business combination in which (a) one or more entities are merged or become subsidiaries, (b) one entity transfers net assets or its owners transfer their equity interests to another, or (c) all entities transfer net assets or the owners of those entities transfer their equity interests to a newly formed entity (some of which are referred to as roll-up or put-together transactions). All those transactions are business combinations regardless of whether the form of consideration given is cash, other assets, a business or a subsidiary of the entity, debt, common or preferred shares or other equity interests, or a combination of those forms and regardless of whether the former owners of one of the combining entities as a group retain or receive a majority of the voting rights of the combined entity. An exchange of a business for a business also is a business combination."

Paragraph 35, general framework for the purchase price allocation of a business combination: "Following the process described in paragraphs 36-46 (commonly referred to as the purchase price allocation), an acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition (refer to paragraph 48)."

Paragraph 39, definition of an intangible asset (other than goodwill): "An intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired entity or from other rights and obligations). If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). For purposes of this Statement, however, an intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability. For purposes of this Statement, an assembled workforce shall not be recognized as an intangible asset apart from goodwill."

Paragraph 43, residual method to value goodwill (i.e., total purchase price - liabilities assumed - financial assets - tangible assets - recognized intangible assets = goodwill): "The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed shall be recognized as an asset referred to as goodwill. An acquired intangible asset that does not meet the criteria in paragraph 39 shall be included in the amount recognized as goodwill."

SFAS 142, Goodwill and Other Intangible Assets

Paragraph 11, estimation of useful life for acquired intangible assets: "The accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life is amortized; an intangible asset with an indefinite useful life is not amortized. The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity."

Paragraph 12, amortization of intangible assets: "A recognized intangible asset shall be amortized over its useful life to the reporting entity unless that life is determined to be indefinite. If an intangible asset has a finite useful life, but the precise length of that life is not known, that intangible asset shall be amortized over the best estimate of its useful life. The method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined a straight-line amortization method shall be used."

Paragraph 14, periodic reconsideration of each intangible's useful life: "An entity shall evaluate the remaining useful life of an intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of an intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset shall be amortized prospectively over that revised remaining useful life."

Paragraph 16, intangibles not subject to amortization: "If an intangible asset is determined to have an indefinite useful life, it shall not be amortized until its useful life is determined to be no longer indefinite. An entity shall evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life."

Paragraph 17, impairment testing of recognized intangibles: "An intangible asset that is not subject to amortization shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. (Paragraph 5 of Statement 121 includes examples of impairment indicators.) The impairment test shall consist of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss shall be recognized in an amount equal to that excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis."

Paragraph 18 provides GAAP requires impairment testing of acquired goodwill: "Goodwill shall not be amortized. Goodwill shall be tested for impairment at a level of reporting referred to as a reporting unit. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value." □

excerpts details of the relevant provisions.

Income Tax Reporting

Like other taxpayers, sports franchise acquirers allocate the acquisition purchase price under either IRC section 338 (for deals structured as qualified stock purchases) or section 1060 (for deals structured as qualified asset purchases). The regulations under both IRC sections 338 and 1060 require the taxpayer to determine the total purchase price paid for the acquisition. Specific rules determine which acquisition-related expenses should be capitalized and also what tax liabilities (assumed or created by the transaction) should be included in the total purchase price. Due to capitalized acquisition expenses and income tax liabilities, the income tax purchase price is typically much greater than the financial accounting purchase price for the same franchise.

Under both IRC sections 338 and 1060, the calculated purchase price is allocated among specifically identified categories, or classes, of acquired assets. Under both sections, the semifinal cate-

gory relates to acquired identified intangible assets, while the final category relates to acquired goodwill. The purchase price amount allocated to goodwill is based on the residual method. The remaining purchase price, after allocations are made to acquired financial assets, personal property, real estate, and identified intangibles, is assigned to goodwill.

In terms of determining the total purchase price paid and allocating it to individual acquired assets, the process for sports franchise owners is basically the same as for any other taxpayer. The process of amortization deductions for acquired intangible assets is distinctly different for sports franchise owners, however, because most taxpayers claim amortization deductions for acquired intangible assets (including acquired goodwill) over a 15-year period, under IRC section 197. IRC section 197(d) defines intangibles, including franchises; section 197(e) expressly excludes sports franchises and items connected with them from the section 197(d) list. The second *Sidebar* lists the specifics of sections 197(d) and (e).

Because of the 197(e) exception, a sports franchise purchase price allocation is different from most acquisitions in two ways:

■ In order to claim amortization deductions, fair market value (FMV) and a remaining useful life (RUL) must be estimated and substantiated for each identified intangible asset; and

■ No amortization deduction is allowed for purchased goodwill (i.e., the amount of residual, unallocated purchase price).

Sports Franchise Intangible Assets

Professional sports franchises have numerous intangible assets that immediately match up to the IRC section 197(d) list of intangibles, as well as others not included on that list. A unique intangible asset is the franchise agreement (and any associated contract) between the national league/association franchisor and the team owner/franchisee. While this franchise is not necessarily the most valuable intangible asset, it is important to the franchise owner.

As with all franchise agreements, sports franchises provide some elements of limited monopolistic economic benefits to the franchise holder. In numerous instances, buyers have paid substantial amounts for "naked" franchises, as in the case of expansion teams; however, a buyer is unlikely to pay a substantial amount for player contracts and stadium rights without the expectation that the franchise will be transferred as well.

Several sports franchise intangibles are related to employees. First, there is a trained and assembled administrative workforce, which includes management, marketing, public relations, customer relations, accounting, and other personnel. Other than a few senior executives, these employees are unlikely to be under contract. Second, there are the coaching and player development staffs, which include scouts, recruiting agents, assistant coaches, physical therapy and medical personnel, and senior coaches. Many but not all of these employees are likely to be under contract. Third are the team players, all of whom are typically under some type of contract.

There are four categories of intellectual property: patents, copyrights, trademarks, and trade secrets. The franchise

IRC SECTION 197

IRC section 197(d) provides the following list of purchased intangible assets that qualify for the 15-year amortization deductions:

Except as otherwise provided in this section, the term "IRC section 197 intangible" means—

- (1) Goodwill,
- (2) Going concern value,
- (3) Any of the following intangible items:
 - (a) Workforce in place (contractual or otherwise),
 - (b) Business books and records, operating systems, or any other information (including lists or other information with respect to current or prospective customers),
 - (c) Any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item,
 - (d) Any customer-based intangible (contractual or otherwise),
 - (e) Any supplier-based intangible (contractual or otherwise), and
 - (f) Any other similar item.
- (4) Any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,
- (5) Any covenant not to compete, and
- (6) Any franchise, trademark, or trade name.

IRC Section 197(e)(6) specifically excepts sports franchises from the above:
(6) Treatment of Sports Franchises—A franchise to engage in professional football, basketball, baseball, or other professional sport, and any item acquired in connection with such a franchise. □

workforce's value generally encompasses that of the organization's trade secrets; for instance, they may have developed specialized systems and procedures related to accounting, administration, player therapeutic procedures, and even player development. These trade secrets may be documented in written standards and manuals. Any such manuals are also intangible assets. Most trade secrets of a sports franchise are encompassed in its employees' collective knowledge and experience.

A franchise may hold copyrights on team songs, brochures, slogans, and related material. Any such copyrights are also acquired intangible assets. Most franchises also have trademarks and trade names (e.g., the team nickname), service marks, associated trade dress, and similar items. The team name and logo may be the source of national or local product licenses, which are a secondary but important income source for the franchise.

In addition to product licenses, many sports franchises have numerous contract-related intangible assets, such as:

- Agreements with concessionaires;
- National or local television or radio broadcasting agreements (which may be negotiated through the national league);
- Favorable supplier contracts for goods or services; and
- Food, beverage, or other product endorsement contracts.

Most franchises either own or lease stadiums. In addition, many franchises either own or lease training facilities and other specialized real estate properties. Obviously, these properties are substantial components of the overall franchise value. Real estate-related contracts are also important intangible assets to franchise holders. These intangibles may include:

- Leasehold interest to the primary stadium property;
- Leasehold interest to training or other specialized facilities;
- Sublease agreements with promoters to present other events at the arena;
- Contracts with advisors to display or broadcast advertisements within the arena;
- Skybox leases and other premium seating; and
- Subleases with restaurants, retailers, and other vendors.

An important intangible asset for many franchises is the customer-related intangible, which typically includes recurring customer relationships with season ticket holders.

Arguably, the most important intangible is the franchise agreement with the national sports league or association. The national franchise agreement may not be the most valuable intangible asset of the franchise owner, but is necessary for realizing the full economic value of all other assets. The operation of all of these assets contributes, at least in part, to the franchise agreement's value. The franchise agreement (and any associated contracts and covenants) may include the following component intangibles:

- National television or radio broadcast revenue-sharing agreements;
- National advertising income or product license royalty-sharing agreements;

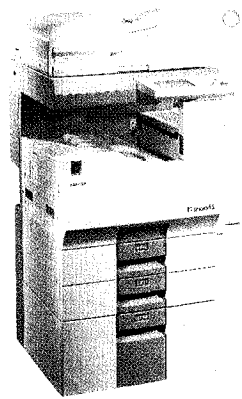
■ Expected ticket sale income from league competition; and

■ Expected income from team events and activities not associated with other intangibles.

Franchise buyers sometimes pay for goodwill. With regard to sports franchises, goodwill is often considered to be the portion of the franchise purchase price that cannot be associated with identified tangible or intangible assets. Under this definition, goodwill is the residual (i.e., remaining) purchase price premium not allocated to any other asset. □

Robert F. Reilly is managing director of Willamette Management Associates (www.willamette.com) and has been an expert witness in many intellectual property disputes. His practice includes valuation consulting, economic analysis,

Leaders can learn.



TOSHIBA
Don't copy. Lead.

NORTHERN
BUSINESS SYSTEMS
"Directing Your Future"

www.northernbusiness.com
Bellerose, NY (516) 616-0170
Mahwah, NJ (201) 825-1100
Westchester, NY (914) 777-6700

Document management software has taught me to scan, store, index, retrieve and send documents...all from your desktop. (You'll love retrieving your documents with a "Google-like" search & saving storage costs!)

LASERFICHE
Document Imaging for the Real World™

New York, NY (212) 736-9200
Rochester, NY (585) 214-4690
Syracuse, NY (315) 437-4102
Cranford, NJ (908) 709-0050