Intangible Asset Identification and Valuation in the Bank and Thrift Industries

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Financial institution participants in the commercial banking and thrift industries typically own and operate several categories of intangible assets. Some of these intangible assets are specific to financial institutions (such as core depositor relationships, credit card portfolios, and mortgage servicing rights), and some of these intangible assets are common to most types of commercial business entities (such as trademarks and trade names, computer software, and a trained and assembled workforce). First, this discussion will introduce the various types of intangible assets that may be encountered in the banking and thrift industries. Second, this discussion will describe the various types of analyses (e.g., valuation, transfer price, economic damages) that may be applied to these financial institutions intangible assets. And, third, this discussion will explain the various reasons (or the client motivations) why financial institutions industry participants may need to perform these intangible asset analyses.

Introduction

Institutions that operate in the banking and thrift industries typically own and operate various categories of commercial intangible assets. For purposes of this discussion, we will define the banking and thrift industries to include the following types of financial institutions: commercial banks, savings and loan associations, mutual savings banks, credit unions, and consumer and/or commercial finance companies.

Although they may also be considered financial institutions, this discussion will not consider insurance companies or pension funds. Also, for purposes of this discussion, the banking and thrift institutions will be referred to as intangible asset owner/operators.

Valuation analysts are often asked by banking and thrift industry participants to value commercial intangible assets for various financial accounting, income taxation, or other purposes. However, these banking and thrift industry participants often need other types of intangible asset analyses—in addition to valuations.

And, banking and thrift industry participants need these analyses for many types of reasons in addition to accounting and tax reasons. For purposes of this discussion, banking and thrift industry participants include financial institutions executives, debt and equity investors, corporate acquirors and joint venturers, government regulators, and taxing authorities.

This discussion will summarize (1) the common categories of intangible assets, (2) the different types of intangible asset analyses, and (3) the numerous reasons for (and the financial institution motivations related to) intangible asset analyses.

In addition to banking and thrift industry participants, financial accountants and auditors, tax and estate planners, lawyers, judicial finders of fact, financial intermediaries, investors, government and regulatory agencies, shareholders and investors, potential licensees and licensors, and other parties all rely on valuation analysts to provide these industry intangible asset analyses.

This is because these various parties may:

1. engage the valuation analyst,
2. review the intangible asset analysis work product, and
3. rely on the intangible asset analysis conclusions.

In particular, banking and thrift industry participants should be aware of the various reasons why financial institutions need intangible asset valuation and related analytical services.

Business Enterprise Asset Categories

All business enterprise assets can be classified as either tangible or intangible. The value of a tangible asset comes from its physical qualities. That is, the tangible asset value comes from its physical functionality, utility, or

appearance. The value of an intangible asset does not come from its physical qualities. Instead, the intangible asset value comes from its economic, legal, or intellectual attributes.

All business enterprise assets can also be classified as either (1) real property or (2) personal property. Real property is typically immobile, because it is affixed to land. Personal property is typically movable. The value of real property comes from rights (e.g., use, occupancy, etc.) related to land. And, the value of personal property does not relate to land.

Accordingly, all business enterprise assets can be classified by a two-by-two matrix of these four categories:

1. tangible assets versus intangible assets and
2. real property versus personal property.

Exhibit 1 illustrates these four categories. And, Exhibit 1 presents several illustrative examples of the types of business enterprise assets that may be classified within each asset category.

Of course, the focus of this discussion relates to one category of intangible assets (i.e., the intangible personal property category).

Exhibit 1
Four Categories of Common Business Enterprise Assets With Illustrative Examples

	Real Property Assets	Personal Property Assets
Tangible Assets	land land improvements building-components building structures	furniture and fixtures trucks and autos computers office equipment
Intangible Assets	leaseholds easements and rights of way mining and mineral rights air rights and water rights	financial assets general intangible assets intellectual property goodwill intangible value

Common Business Enterprise Intangible Asset Categories

The value of business enterprise intangible assets comes from the legal rights, the intellectual content, and the expected economic benefits that are associated with the intangible asset. Like all assets (i.e., both tangible and intangible assets), commercial intangible assets can be owned and have value.

The typical commercial intangible asset categories are as follows:

1. **Financial assets.** Banking and thrift industry participants are familiar with financial assets. Common examples of financial assets include: cash, accounts and notes receivable, stocks and bonds, and other negotiable investment securities. When the financial assets are owned by the banking entity, these intangible assets are recorded as "current assets" for financial statement accounting purposes.
2. **General intangible assets**. This second category includes most other commercial intangible assets. Because this category is quite broad, most intangible personal property and intangible real property assets are classified as general intangible assets.
3. **Intellectual property.** Intellectual property assets are distinguished by their special legal recognition and specific legal rights. There are four (and only four) types of intellectual property assets:
   a. trademarks,
   b. patents,
   c. copyrights, and
   d. trade secrets.
4. **Intangible value in the nature of goodwill.** Intangible value in the nature of goodwill is often considered to be a residual intangible asset. That is, for valuation purposes, goodwill is often quantified as the intangible value component of a banking entity (of whatever legal structure or form) that cannot be specifically assigned to, or specifically identified with, any of the other three types of commercial intangible assets.

   Nonetheless, like the other three intangible asset categories, banking and thrift entity goodwill can be owned, and it can have value.

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Commercial Intangible Asset Listing

There is no single list of all generally accepted commercial intangible assets. Valuation analysts may refer to various lists of intangible assets for various purposes.

For various accounting purposes, most valuation analysts often refer to the FASB Statement of Financial Accounting Standards No. 141R or the IASB International Financial Reporting Standards No. 3 listings of recognized intangible assets.

For various taxation purposes, most valuation analysts may refer to the intangible asset listings in Internal Revenue Code Sections 197 and 482.

For various litigation purposes, most valuation analysts may refer to the intangible asset listing in the American Institute of Certified Public Accountants Consulting Services Practice Aid 99-2, entitled *Valuing Intellectual Property and Calculating Infringement Damages*.

Banking and Thrift Industry Commercial Intangible Assets

There are several commercial intangible assets that are common to the banking and thrift industries. These common banking and thrift industry intangible assets are summarized below:

1. Core depositor relationships—This intangible asset is often defined as the ability of the bank or thrift to raise capital from low-cost demand deposit and time deposit accounts (compared to higher cost jumbo CDs or other capital sources)
2. Mortgage and other loan servicing relationships—This intangible asset is typically considered to be the expected profit to be earned from servicing the mortgage or other type of loan portfolio over the expected remaining useful life of the current loan portfolio
3. Credit card customer relationships—This intangible asset is typically considered to be the expected profit to be earned from interest, fees, and charges on the expected outstanding balance amounts over the expected remaining useful life of the current card portfolio/customer relationships
4. Consumer/commercial finance customer relationships—This intangible asset is typically considered to be the expected profit to be earned from interest, fees, and charges on both the remaining loan balance and the expected loan renewals over the expected remaining useful life of the recurring customer relationship
5. Leasing customer relationships—This intangible asset is typically considered to be the expected profit to be earned from interest, fees, charges, and residual value gains over the remaining terms of the current leases and the remaining terms of any expected lease renewals
6. Regulatory operating approvals—This intangible asset is often considered to include the going-concern value (often measured as the permit application period opportunity cost) associated with all of the financial institution's required national, state, or other regulatory licenses and permits
7. Computer software—This intangible asset category includes both (a) the account management and banking operations software and (b) the financing accounting software (whether purchased or proprietary) and the associated databases that operate on the institution's software
8. Manuals, systems, and procedures—This intangible asset category includes the manual and the automated documentation of "how we do things here" at the subject financial instruction
9. Service marks and service names—This intangible asset category includes the brand awareness, name recognition, and customer loyalty associated with the name of the bank and with the names of all of the bank's proprietary products and services
10. Trained and assembled workforce—This intangible asset category is often quantified as the cost to recruit, hire, and train all of the subject institution's management, administrative, and account personnel

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However, there is substantial intangible asset value associated with most going-concern financial institutions (including those financial institutions that are less profitable than their relevant peer group). And, in addition to general institutional goodwill, most of that intangible asset value will relate to some (or most) of the above-listed commercial intangible assets.

Common Types of Banking and Thrift Industry Intangible Asset Analyses

While there are numerous individual types of financial institution intangible asset analyses, all of these individual analyses are typically grouped in the following five analysis categories:

1. Valuation—This category includes analyses performed to estimate a defined value of a specified intangible asset ownership interest as of a specific date. The defined values may include fair value, fair market value, investment value, use value, acquisition value, collateral value, owner value, etc.

This type of analysis typically includes the valuation analyst's consideration of the three generally accepted intangible asset valuation approaches: the cost approach, the income approach, and the market approach.

2. Transfer price—This category includes analyses performed to measure a third party license royalty rate or an intercompany transfer price for the use of an intangible asset. The fair, arm's-length standard is the most common (but not the only) transfer pricing standard.

   The intangible asset royalty rate, or other transfer price conclusion, is usually set for a specific time period (e.g., 1, 5, or 10 years) associated with the contractual term of the license agreement.

3. Lifing—This category includes analyses performed to quantify the intangible asset expected remaining useful life, the periodic rate of obsolescence or intangible asset value decrease, and/or the intangible asset residual value (say, at the end of a license agreement).

4. Damages—This category includes analyses performed to determine the amount of lost profits or other economic damages associated with a specific damages event that affected the commercial intangible asset. These types of intangible asset damages usually relate to either:

   a. a breach of contract (e.g., the breach of a noncompetition agreement) or
   b. a tort (e.g., an intellectual property infringement).

   The damages amount will typically be expressed either as a dollar amount or as a royalty rate.

   An intangible asset damages analysis typically includes the valuation analyst's consideration of:

   a. the "but for" method,
   b. the yardstick method,
   c. the before and after method, and
   d. similar economic damages measurement methods.

5. Fairness—This category includes analyses performed to assess the absolute and/or relative fairness of a proposed or actual intangible asset transfer transaction. Such a commercial intangible asset transaction may include a sale, license, or some other type of transfer.

   This type of intangible asset analysis usually includes the valuation analyst's consideration of both:

   a. the price of the transaction and
   b. the terms of the transaction.

   This type of analysis usually specifies the transactional fairness to an identified party (e.g., to the buyer, seller, licensor, licensee, debtor, creditor, joint venturer, etc.).

The generally accepted approaches, methods, and procedures vary for each of these five types of commercial intangible asset analyses. However, valuation analysts typically use the same set of quantitative and qualitative skills to perform each of these different types of commercial intangible asset analyses.

Reasons to Analyze Financial Institution Commercial Intangible Assets

There are many reasons why bank or thrift industry participants request the valuation analyst to perform a commercial intangible asset analysis. However, most of these reasons—or financial institution client motivations—can be grouped into the following ten categories:

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1. intangible asset sale/license transaction pricing and structuring
2. intercompany use and intangible asset ownership transfers
3. financial accounting and reporting
4. taxation planning and compliance
5. financing collateralization and securitization
6. infringement (and related) litigation claims and commercial dispute resolution
7. corporate management information and strategic planning
8. corporate governance and regulatory/contractual compliance
9. bankruptcy, restructuring, and reorganization analysis
10. license, joint venture, and other intangible asset development or commercialization opportunities

Each of these ten categories of commercial intangible asset analysis reasons, or financial institution client motivations, is further explained below.

Transaction Pricing and Structuring

Financial institutions often need assistance from the valuation analyst with regard to negotiating and/or designing an

intangible asset license or sale transaction. Such intangible asset transactions may involve either:

1. the license/sale of an individual intangible asset (often called a "naked" sale) or
2. the license/sale of a bundle of related intangible assets (e.g., all of the intangible assets of a particular bank branch or financial product/service line).

Some of the individual intangible asset analyses related to this category include the following:

1. negotiating, pricing, and structuring the terms of an intangible asset sale transaction
2 negotiating and structuring the terms of an intangible asset license (e.g., royalty rate, product and geography limitations, contract term, sublicense rights, etc.)
3. providing a fairness opinion regarding the intangible asset sale/license (related to price and terms)
4. providing a private inurement or excess benefits opinion regarding a sale/license transaction involving a not-for-profit financial institution
5. concluding or negotiating a purchase/sale price for a financial business services portfolio or financial product/service line, based on the value of its commercial intangible assets

"Most bank or thrift industry executives are familiar with the fair value valuation of intangible assets for GAAP-related accounting and financial reporting reasons."

Intercompany Transfer Price

Financial institutions also may need assistance from the valuation analyst with the intercompany sale or license of a commercial intangible asset. These intercompany transfers can relate to product cost accounting, management information, state income tax, and federal income tax issues.

Such a transfer price is important to a parent financial corporation (or holding company) when (1) business unit A owns (and developed) a patent, trademark, software, etc. and (2) business unit B uses the intangible asset to produce and sell a product/service. This type of transfer price analysis determines: how much does unit B have to pay unit A for the right to use (or for the ownership transfer of) unit A's intangible assets.

Some of these intangible asset transfer price–related analyses include the following:

1. cost accounting allocation for the intercompany use of intangible assets
2. transfer of the financial institution intangible assets (e.g., trademark or trade name) to a holding company (in a low/no income tax state) for purposes of licensing the intangible asset to sister operating companies (in high income tax states)
3. transfer the use of a commercial intangible asset between a U.S. taxpayer corporation and a controlled foreign taxpayer corporation (whether an inbound or outbound transfer of the intangible asset use). The Internal Revenue Code Section 482 regulations provide for very specific transfer price methods to be used for this purpose.

   These intercompany transfer price methods include:

   a. the cost plus method,
   b. the comparable profit margin method, and
   c. several profit split methods.
4. transfer of ownership of a commercial intangible asset between a U.S. taxpayer corporation and a controlled foreign taxpayer corporation. Such intercompany transfers often involve an intangible asset transfer from the U.S. to a low/no income tax rate country.
5. intercompany use of a commercial intangible asset between a wholly owned subsidiary and a non-wholly-owned subsidiary (including instances where the non-wholly-owned subsidiary minority stockholders may want assurance regarding the fairness of the intercompany transfer price)

Financial Accounting

Most bank or thrift industry executives are familiar with the fair value valuation of intangible assets for GAAP-related accounting and financial reporting reasons. Some of the more common GAAP-related valuation analysis reasons include the following:

1. the acquisition accounting allocation of a merger or acquisition transaction purchase price
2. the periodic testing for the impairment of acquired goodwill and other intangible assets
3. the periodic testing for the impairment of long-lived (i.e., amortizable) intangible assets
4. the fresh start accounting for a financial services company that is emerging from a bankruptcy
5. the recording of the business owners' intangible asset contributions to a new business formation (e.g., to a joint venture formation)

Taxation Planning and Compliance

In addition to the intercompany transfer price considerations mentioned above, bank and thrift institutions managements may request the valuation analyst to value commercial intangible assets for various federal, state, and local taxation purposes, including the following:

1. Federal income tax purposes include charitable contribution deductions, worthless security deductions (e.g., of an intellectual property holding company), basis of intangible assets contributed to/distributed from a partnership, basis and amortization deductions related to a business purchase price allocation, and other reasons.
2. Federal gift and estate tax purposes often relate to the lifetime transfers of—or a decedent's personal ownership in—the subject intangible assets; this type of analysis also relates to the transfer of an ownership in a financial services line of business where the value depends on the business unit intangible assets.
3. State and local property tax purposes relate to jurisdictions where commercial intangible assets are either specifically exempt from—or are specifically subject to—ad valorem property taxation.
4. Planning to minimize the shareholder double taxation on the sale of a closely held banking institution when the transaction can be structured as (a) in part a sale of the corporation assets (subject to double taxation) and (b) in part a sale of personally owned intangible assets (subject to single taxation only).

   This type of sale transaction structure is exemplified in the 1998 U.S. Tax Court decision *Martin Ice Cream Co.*, where the sole corporation shareholder sold both:

   a. the business-owned tangible and intangible assets and
   b. personally owned distribution agreements, retail customer relationships, and industry expertise.

Financing Transactions

Particularly during periods of tight credit, financial institutions may use commercial intangible assets as a source of collateral for various types of financing transactions. These financing-related intangible asset analyses often include the following:

1. collateral valuations (of intangible assets and of related licenses) for cash flow–based financing and for asset-based financing
2. current value valuations and terminal value valuations for sale/licenseback financings
3. solvency opinions (of the debtor corporation) prepared for creditors to avoid fraudulent conveyance claims

Litigation Claims

Financial institutions (and their legal counsel) may retain the valuation analyst to perform lost profits and other economic damages analyses (e.g., market analyses for convoyed or derivative products/services, analysis of mitigation actions, etc.) for the following dispute-related purposes:

1. intellectual property infringement
2. breach of supply, services, purchase, or other commercial contract
3. breach of noncompete or confidentiality agreement
4. dissipation of corporate assets/shareholder oppression claims
5. eminent domain and condemnation disputes
6. IP license agreement disputes
7. breach of development, commercialization, or joint venture agreements
8. shareholder disputes related to professional practices or professional services firms
9. family law disputes, often related to the issue of personal goodwill versus institutional goodwill in the family-owned banking entity
10. fraud and misrepresentation related to financial institution mergers and acquisitions

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Management Information and Strategic Planning

Financial institution managements need to know what intangible assets they own, so they can develop operational and strategic plans to maximize the value of these assets. These planning-related intangible asset analyses include the following:

1. an inventory and valuation of intangible assets to identify financing, licensing, spin-off, or other commercial opportunities
2. remaining useful life estimates in order to assess the reasonableness of long-term strategic plan assumptions
3. development of executive compensation incentive plans, based on periodic intangible asset valuations, return on asset (or other investment) calculations, and related valuation factors

4. assessment of the reasonableness of intangible asset sale/license transactions between the financial institution and an insider (e.g., a director, executive, controlling stockholder)

Corporate Governance and Regulatory Compliance

In this post-Sarbanes-Oxley environment, publicly traded financial institution managements are concerned about the governance of all corporate assets (both tangible and intangible). And, not-for-profit finance organization managements are also concerned about income tax regulations and other federal and state statute regulatory compliance issues.

These corporate governance and regulatory compliance issues include the following:

1. valuation of commercial intangible assets in order to assess the reasonableness of business interruption and other insurance coverage
2. an inventory of the institution's commercial intangible assets to document accounting control and protection of all corporate assets
3. fair market value appraisals of all commercial intangible assets bought or sold by a not-for-profit financial entity
4. fair market value appraisals of all commercial intangible assets licensed by/to (or of professional services provided by/to) a not-for-profit financial entity

"Many financial institution managements may need help from the valuation analyst to identify intangible asset license and other commercialization opportunities. Even more financial institution managements need help to analyze the costs and benefits of such potential opportunities."

Bankruptcy and Reorganization

Parties involved in a bankruptcy may include the debtor-in-possession (DIP), DIP insiders, DIP financing sources, various creditors and creditor committees, their respective legal counsel, the bankruptcy trustee, potential intangible asset licensors/licensees, parties who did or will transact with the DIP, and other interested parties.

These parties are typically concerned about:

1. the value of their claims,
2. maximizing cash flow opportunities,
3. the fairness of transactions involving the bankruptcy estate, and
4. the relative fairness of and the feasibility of a proposed reorganization plan.

These bankruptcy-related intangible asset issues involve the following:

1. valuation of any commercial intangible assets that serve as a creditor's collateral
2. valuation of commercial intangible assets included in a solvency analysis with respect to preference and fraudulent conveyance claims
3. identification of any cash flow generation intangible asset license or spin-off opportunities
4. assessment of the fairness of DIP intangible asset sales/licenses
5. analysis of the effect on the debtor intangible assets of the feasibility of the proposed plan of reorganization
6. implementation of the post-bankruptcy fresh-start accounting provisions for the debtor entity, according to AICPA SOP 90-7

License and Commercialization Opportunities

Many financial institution managements may need help from the valuation analyst to identify intangible asset license and other commercialization opportunities. Even more financial institution managements need help to analyze the costs and benefits of such potential opportunities.

These intangible asset license agreement analyses may include the following:

1. analysis of the costs (e.g., the future commitments) and benefits (e.g., the license royalties) of a proposed license agreement.
2. analysis of the costs and benefits (in terms of risk and return on investment) of a proposed joint venture (JV) development agreement—typically compared to an independent intangible asset development plan; the analysis typically includes consideration of:
   a. intangible asset contributions to the JV formation and
   b. intangible asset distributions from the JV dissolution.
3. analysis of the costs and benefits of a third-party development or commercialization agreement, where one party to the agreement owns the commercial intangible asset and the other party to the agreement operates the commercial intangible asset

4. alternative analyses of various development or other agreement terms and conditions (e.g., up-front payments, milestone payments, royalty rates, territories covered, products covered, required development/promotion/etc. expenditures, contract periods, residual values, etc.).

Intangible Asset Valuation Analysts

The valuation analyst selected by the financial institution management (or other party) should have the experience and expertise necessary to perform these various types of intangible asset analyses.

In order to best serve the subject financial institution, the valuation analyst should understand:

1. the various types of intangible asset analyses that financial institutions may need, and
2. the various reasons why these financial institutions may need these intangible asset analyses.

Some financial institution managements (and their legal counsel) may engage various types of professionals to perform these intangible asset analyses. These other types of professionals may include economists, academics, banking industry consultants, licensing executives, investment bankers, business appraisers, and others.

> *"Most banks and thrifts own and/or operate a variety of commercial intangible assets. This statement is true both for closely held financial institutions and for publicly traded financial institutions."*

Each of these types of professionals have their own strengths and weaknesses. However, few of these professionals can offer the bank and thrift industry clients the unique combination of financial analysis, empirical research, due diligence, and practical experience skills that CPA valuation analysts can provide.

CPA valuation analysts should be familiar with (1) bank and thrift financial accounting, (2) financial institutions regulatory requirements, (3) bank and thrift taxation provisions, and (4) industry-specific micro-economic factors that drive bank and thrift industry values. Few other professionals have the unique combination of accounting, taxation, economic analysis, and strategic consulting skills that are common to experienced CPA valuation analysts.

Summary and Conclusion

Most banks and thrifts own and/or operate a variety of commercial intangible assets. This statement is true both for closely held financial institutions and for publicly traded financial institutions. This statement is also true for participants in virtually every sector of the financial institutions industry.

The demand for commercial intangible asset analyses is increasing in virtually every one of the financial institution motivation categories discussed above. When the current conditions in the bank and thrift industries are compared to, say, several years ago:

1. there are more litigation claims related to commercial intangible assets,
2. there is the rapidly approaching implementation of fair value accounting requirements,
3. there is an increased number of corporate bankruptcy filings,
4. there is a substantial increase in intellectual property license transactions,
5. there is an increasing need for almost all financial institutions to raise financing, and
6. there is an increased industry emphasis on corporate governance, accounting controls, and regulatory compliance.

All of these trends indicate an increased demand by the banking and thrift industries for commercial intangible asset analysis services. Many valuation analysts currently value banking and thrift industry intangible assets for financial accounting, family law, and other "plain vanilla" purposes.

With the appropriate bank and thrift industry experience and expertise, these valuation analysts should be able to:

1. identify financial institution intangible assets and
2. estimate the value, transfer price, or damages related to the industry-specific intangible assets described above.

Again, with the appropriate bank and thrift industry expertise, these valuation analysts should be able to provide many more types of commercial intangible asset analyses—for many more types of bank and thrift industry client purposes.

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