The Cost Approach and the Intangible Asset Valuation Assignment

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The cost approach is particularly applicable to certain types of intangible assets and for certain types of intangible asset valuation engagements. This discussion summarizes (1) the many reasons to value intangible assets and (2) the many types of commercial intangible assets. And, this discussion summarizes the common elements of the intangible asset valuation engagement.

Introduction

There are numerous reasons why the valuation analyst may be asked by the intangible asset owner/operator (or by some other party) to perform an intangible asset valuation. Many of these reasons are listed in Exhibit 1.

Common Types of Intangible Assets

There is no single generally accepted list of all intangible assets. However, this discussion will present two lists of intangible assets (one for financial accounting applications and one for tax accounting applications) that valuation analysts frequently refer to.

In order for an asset to qualify as an intangible asset, it is generally accepted that the asset should be an asset and should be intangible.

The Financial Accounting Standards Board (FASB) offers a practical description of an asset in Statement of Financial Accounting Concepts No. 6 (CON 6). CON 6 provides the following definition of an asset:

> Probable future economic benefits obtained or controlled by a particular enterprise as a result of past transactions or events.

The following three characteristics should also be present in order for something to qualify as an asset:

1. The asset should provide probable future economic benefit that enables it to provide future net cash inflows.
2. The entity should be able to receive the benefit and to restrict others' access to it.
3. The event that provides the entity with the right to receive the benefit has occurred.

All of the above characteristics should be present to meet the definition of an asset. Under the CON 6 definition, an asset can still be recognized as an asset even if it cannot be exchanged, provided that the entity that owns it can use it in a manner that generates future cash flow or other benefits. Also, rights to the asset need not be legally enforceable if the rights can be enforced in other ways, such as by using social or moral persuasion.

Intangible assets are assets that have no physical substance. The value of an intangible asset is based on the rights or privileges to which the owner/operator is entitled. The FASB accounting standards codification (ASC) 350 provides further definitions that are relevant to an intangible asset.

ASC 805-20-55 provides one list of intangible assets that valuation analysts frequently refer to for financial accounting purposes. This ASC list is specifically intended to present the identifiable

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Reasons to Conduct an Intangible Asset Valuation

1. Transaction pricing and structuring:
   - Pricing the arm's-length sale of an individual intangible asset or a portfolio of two or more intangible assets
   - Pricing the arm's-length license of an individual intangible asset or a portfolio of two or more intangible assets
   - Calculating an exchange ratio between two owners for two respective intangible asset portfolios
   - Measuring the equity allocations in a new business enterprise or joint venture when one or more parties contribute intangible assets
   - Measuring the asset distributions in a liquidating business enterprise or joint venture when one or more of the parties receive intangible assets
   - Pricing the transfer of an intangible asset between two wholly owned subsidiaries (or between two unequally owned subsidiaries) of a consolidated business enterprise
2. Financing collateralization and securitization:
   - Using an intangible asset as the collateral in either a cash-flow-based or an asset-based debt financing
   - Arranging the sale/licenseback financing of a commercial intangible asset
3. Taxation planning and compliance:
   - Forming an intangible asset holding company and structuring the intercompany intangible asset license to the taxpayer's operating companies
   - Performing income tax basis purchase price allocations (among the acquired tangible assets and intangible assets) in a taxable business acquisition (e.g., an Internal Revenue Code Section 1060 asset acquisition)
   - Quantifying the amortization deduction for a purchased intangible asset
   - Valuing intangible assets in the taxpayer corporation insolvency exemption (Section 108) related to cancellation of debt (COD) income recognition
   - Valuing corporation intangible assets related to the built-in gain (BIG) tax deferral related to the taxpayer election to convert from C corporation to S corporation
   - Supporting the charitable contribution deduction for a donated intangible asset
   - Estimating the arm's-length price (ALP) for the cross border transfer and use of a multinational taxpayer corporation's intangible asset (related to Section 482 compliance)
   - Complying with state and local ad valorem property taxation of either taxable or tax exempt intangible assets
   - Defending against IRS allegations of private inurement, excess benefits, or intermediate sanctions with regard to intangible asset transfers between a for-profit entity and a not-for-profit entity.

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Reasons to Conduct an Intangible Asset Valuation

4. Regulatory compliance and corporate governance:
   - Estimating the fair market value estimation of the intangible asset sale, license, or other transfer between a for-profit entity and a not-for-profit entity
   - Performing the fair market value valuation (using the asset-based approach) of a going concern business enterprise to be sold between a for-profit entity and a not-for-profit entity)
   - Documenting the custodial inventory and management of owned and licensed intangible assets
   - Assessing the adequate insurance coverage for owned and licensed intangible assets
   - Defending against infringement, misappropriation, diversion, other torts, breach of contract, and other wrongful acts to intangible assets
   - Defending against allegations of dissipation of corporate assets
5. Bankruptcy and reorganization:
   - Valuing an intangible asset that is pledged as collateral for secured creditor financing
   - Using an intangible asset as collateral for debtor-in-possession (DIP) secured financing
   - Opining on the fairness (to, for example, creditors) of the sale or license of an intangible asset as a DIP cash generation spinoff opportunity
   - Valuing an intangible asset in the performance of the debtor corporation solvency or insolvency tests (particularly the so-called balance sheet test) with respect to fraudulent transfer claims and preference actions
   - Measuring the impact of the intangible assets on the plan of reorganization of the bankrupt owner/operator
6. Financial accounting and fair value reporting:
   - Preparing the acquisition accounting (i.e., the transaction purchase price) allocation among acquired tangible assets and intangible assets
   - Testing for goodwill impairment and for other intangible asset impairment
   - Preparing the post-bankruptcy fresh start accounting for the emerging entity tangible assets and intangible assets
7. Forensic analysis and dispute resolution:
   - Calculating an intangible asset lost profits, reasonable royalty rate, or other economic damages analysis in infringement or other tort claims
   - Measuring intangible asset lost profits or other economic damages in breach of contract, license, or noncompete/nondisclosure agreement damages claims
   - Estimating intangible asset valuation in condemnation, expropriation, eminent domain, or dissipation of corporate assets claims

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Reasons to Conduct an Intangible Asset Valuation

8. Strategic planning and management information:
   - Forming an intangible asset joint venture agreement, joint development agreement, or joint commercialization agreement
   - Negotiating an inbound or outbound intangible asset use, development, commercialization, or exploitation agreement
   - Identifying and negotiating of intangible asset license, spin-off, joint venture, and other commercialization opportunities

intangible assets that should be recognized for acquisition accounting purposes. Nonetheless, the ASC 805-20-55 list does illustrate the many different types of intangible assets.

ASC 805-20-55 organizes the identifiable intangible assets into the following five categories:

1. Marketing intangible assets
2. Customers or clients intangible assets
3. Artistic works intangible assets
4. Contractual intangible assets
5. Technological intangible assets

The identifiable intangible assets included in each of the five ASC 805-20-55 categories are presented in Exhibit 2.

Another list of intangible assets that valuation analysts commonly refer to is the Internal Revenue Code Section 197 ("Section 197") intangible assets. Again, this list is not intended to be comprehensive (i.e., to include all possible intangible assets). Section 197 specifically lists intangible assets (including goodwill and going concern value) that are subject to a statutory 15-year amortization period.

By statute, not all intangible assets qualify as Section 197 intangible assets. Even if they are purchased for use in the taxpayer's going concern business enterprise, not all intangible assets qualify as Section 197 intangible assets.

The list of the Section 197 amortizable intangible assets is presented in Exhibit 3.

While neither the ASC 805-20-55 list nor the Section 197 list is comprehensive, these lists collectively provide a reasonable representation of many intangible assets.

Some valuation analysts may also consider another intangible asset categorization regime. That is, some valuation analysts categorize intangible assets by the most likely valuation approach. For example, some analysts may group intangible assets into the following categories:

1. Income-producing intangible assets, such as customer relationships, professional or administrative services agreements, and supplier agreements—the income approach is often used to value intangible assets that generate a measurable revenue increase or expense decrease.
2. Intangible assets that may be sold or licensed (independent from the associated business enterprise), such as certificates of need, trademarks and trade names, favorable equipment or real estate leases—the market approach is often used to value intangible assets for which the analyst can obtain market-derived pricing multiples or license royalty rates.
3. Fungible intangible assets that are used to support the business entity operations, such as work station/employee manuals and procedures documentation, computer software and electronic files, and an assembled workforce—the cost approach is often used to value these "back room" intangible assets that contribute to the owner/operator's business efficiency and effectiveness.

The valuation analyst will typically consider the application of each valuation approach in each intangible asset valuation assignment. The above categorization simply indicates the valuation approach that may commonly apply to various intangible assets.

Elements of the Valuation Assignment

Before the valuation analyst can select the appropriate approach (or approaches) to apply to the intangible asset valuation, the analyst should develop a comprehensive understanding of the overall valuation assignment. That is, the elements of the valuation assignment should be clearly defined and agreed upon between the analyst and the client.

Some of the common elements of an intangible asset valuation engagement include the following:

1. Purpose and objective of the valuation
2. Standard of value
3. Premise of value
4. Valuation date
5. Description of the subject intangible asset
6. Description of the subject bundle of legal rights
7. Parties who may rely on the valuation
8. Any special reporting requirements

One important element of the valuation is the purpose of the engagement. This element is sometimes also referred to as the function of the engagement. This element answers the question: What type of opinion does the client want the analyst to conclude?

Particularly with regard to intangible assets, the client (or other party, such as the client's legal counsel) may request a "valuation"—even when a slightly different analysis is more appropriate to the client's needs.

Some of the common purposes for which a client (or the client's legal counsel) may request an intangible asset "valuation" are listed below:

1. Estimate a sale price between a willing buyer and a willing seller
2. Estimate a license royalty rate between a willing licensor and a willing licensee
3. Estimate a value to the current owner/operator
4. Estimate a value to a specific buyer owner/operator
5. Estimate an intercompany transfer price (or arm's-length royalty rate) between related (or "controlled") parties

Exhibit 2
ASC 805-20-55 List of Identifiable Intangible Assets

Marketing-Related Intangible Assets:

1. Newspaper mastheads
2. Trademarks, service marks, trade names, collective marks, certification marks
3. Trade dress
4. Internet domain names
5. Noncompetition agreements

Customer-Related Intangible Assets:

1. Customer lists
2. Customer contracts and related customer relationships
3. Noncontractual customer relationships
4. Order or production backlogs

Artistic-Related Intangible Assets:

1. Plays, operas, ballets
2. Books, magazines, newspapers, and other literary works
3. Musical works such as compositions, song lyrics, and advertising jingles
4. Photographs, drawings, and clip art
5. Audiovisual material including motion pictures, music videos, television programs

Contract-Based Intangible Assets:

1. License, royalty, standstill agreements
2. Advertising contracts
3. Lease agreements
4. Construction permits
5. Construction contracts
6. Construction management, service, or supply contracts
7. Broadcast rights
8. Franchise rights
9. Operating rights
10. Use rights
11. Servicing contracts
12. Employment contracts

Technology-Based Intangible Assets:

1. Patented or copyrighted software
2. Mask works
3. Unpatented technology
4. Databases
5. Trade secrets

Exhibit 3
Internal Revenue Code Section 197
List of Amortizable Intangible Assets

- Goodwill
- Going concern value,
- Any of the following items:
  - Workforce in place
  - Business books and records, operating systems, or any other information base
  - Any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item
  - Any customer-based intangible
  - Any supplier-based intangible, and any other similar item
- Any license, permit, or other right granted by a governmental unit or agency or instrumentality thereof
- Any covenant not to compete entered into in connection with an acquisition of a trade or business
- Any franchise, trademark, or trade name

Identical intangible asset lists are also provided in the regulations related to Internal Revenue Code Sections 482 and 936.

6. Estimate lost profits, a reasonable royalty rate, or other economic damages related to a damages event
7. Conclude the fairness of a sale price or a license royalty transaction
8. Conclude a mutual exchange ratio for two bundles of intangible assets
9. Estimate a prospective value at a future date (e.g., at the end of a license period)
10. Estimate a remaining useful life (RUL) for an intangible asset

The valuation engagement purpose relates to a client's specific informational or other need.

Depending on that specific need, the client (or the client's legal counsel) will instruct the valuation analyst as to the appropriate standard (or definition) of value. The standard of value basically asks the question: Value to whom?

The following list presents some of the common alternative standards of value that may apply in an intangible asset valuation assignment:

1. Fair value
2. Fair market value
3. Use value
4. User value
5. Owner value
6. Investment value
7. Acquisition value
8. Collateral value
9. Strategic value
10. Intrinsic value

The premise of value answers the question: How will the assumed transaction (between the parties specified in the standard of value) take place? Valuation analysts often consider the premise of value as answering the question: What is the appropriate secondary market in which the assumed transaction will take place?

Often, the client (or the client's legal counsel) will instruct the valuation analyst as to the appropriate premise of value. If there is no such client instruction, then the analyst may select the appropriate premise of value based on the intangible asset's highest and best use (HABU).

The following list presents some of the alternative premises of value that may apply in an intangible asset valuation assignment:

1. Value in continued use
2. Value in place (not in use)
3. Value in exchange—orderly disposition
4. Value in exchange—voluntary liquidation
5. Value in exchange—involuntary liquidation

Depending on the purpose and objective of the valuation, the analyst may conclude the intangible asset HABU to: the current owner/operator, a new owner/operator, or a willing licensor/willing licensee.

The valuation date is a fundamental element of every valuation assignment. The client (or the legal counsel) will instruct the analyst as to the appropriate valuation date. Related to any intangible asset analysis, the valuation date can be (1) historical, (2) contemporaneous, or (3) prospective.

The valuation analyst should have a clear understanding of the intangible asset subject to valuation. The description of the intangible asset should be sufficient to avoid any confusion as to what intangible asset is included in—or excluded from—the valuation analysis.

This intangible asset description may refer to license or contract dates, registration or other identification numbers, physical locations, descriptive listings, or any other designation that would allow the analyst (and the valuation report reader) to identify the subject intangible asset.

To the extent possible, the description should include all associated intangible assets. For example, the intangible asset may include all of the internally developed computer software owned and operated at Client Corporation, including the software source code, and all associated copyrights, system documentation, and operator or user manuals.

The next common element in the valuation engagement is the identification/bundle of intangible asset legal rights subject to analysis. The following list presents some of the alternative bundles of rights that may be included in the intangible asset valuation:

1. Fee simple
2. Term/reversion interest
3. Licensor/licensee interest
4. Sublicensee's interest
5. Domestic/international interest
6. Product line/industry interest
7. Life/residual interest
8. Use rights
9. Development rights
10. Commercialization rights

The valuation analyst will want to know what party or parties will rely on the intangible asset valuation. Any limitations on the distribution of the valuation analysis and/or valuation report are typically described in the client engagement letter. These limitations on distribution are described again in the valuation report. An intangible asset valuation prepared for one use and one user may simply not be applicable to a different use and a different user.

"An intangible asset valuation prepared for one use and one user may simply not be applicable to a different use and a different user."

The valuation analyst will want to develop a clear understanding as to the client (or the client's legal counsel) expectations regarding the valuation report. The valuation analyst will need to know if the client expects (and needs) a more comprehensive valuation report or a summary valuation report.

The valuation analyst will need to know if the report should comply with any statutory, judicial, or administrative reporting standard. An example of such a valuation report would be an expert report prepared in accordance with the Federal Rules of Evidence (FRE) Rule 26.

Summary and Conclusion

There are many reasons why an owner/operator (or its legal counsel) may need an intangible asset valuation. For example, such valuations are performed for taxation, financing, license, litigation, and other purposes—in addition to financial accounting purposes. Many valuations result in value estimates other than fair market value or fair value—such as owner value, collateral value, user value, acquisition value, and so forth.

And, many intangible asset "valuations" don't conclude a "value" at all. Rather, such analyses conclude a transfer price, a royalty rate, a RUL, a lost profits/economic damages conclusion, or other qualitative conclusion.

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