

UNDERSTANDING THE ANALYTICAL STRUCTURE FOR VALUING INTANGIBLE ASSETS, AND THE REASONS UNDERLYING THE PRINCIPAL PROCEDURES, WILL ENABLE ANALYSTS TO MORE EASILY SOLVE COMPLEX VALUATION PROBLEMS.

INTANGIBLE ASSET VALUATION PROCESS

Identifying the right question is sometimes more difficult than concluding the correct valuation.

intangible asset valuation assignment is to analyze projections of future economic events. Such events may include (1) the generation of intangible asset owner (e.g., license) income, (2) the generation of intangible asset operator (e.g., business operations) income, and (3) the proceeds from an intangible asset sale or other transfer.

In many ways, an intangible asset valuation is the culmination of the analyst's research into the expected future economic performance of the intangible asset. This exploratory research typically includes these general analytical procedures:

- Question.
- Analyze.
- Test.
- Conclude.

The valuation process expands these four general analytical procedures as follows:

1. Identify the intangible asset valuation problem.
2. Collect, confirm, and analyze relevant empirical data.
3. Select and apply one or more of the three generally accepted valuation approaches.
4. Estimate the defined value conclusion.

The intangible asset value estimate is sensitive to the prevailing economic conditions as of the valuation date. Therefore, actual economic events that have taken place subsequent to the valuation date are typically relevant only to the extent that they were predictable as of the valuation date. That is, the analyst is asked to estimate the intangible asset value without the benefit of certain knowledge of future events. In contrast to a damages or other type of economic analysis, the analyst performs the intangible asset valuation

considering only the events that could reasonably be expected to occur after the valuation date. In a retrospective valuation assignment, this perspective on what constitutes known or knowable empirical data is particularly important.

Predicting Future Events

One procedure in the intangible asset valuation process, then, is to make reliable predictions of future economic events. If the predictions are reasonably accurate, then the intangible asset value conclusion will be reasonable and supportable. If the predictions are not reasonably accurate, then the valuation procedures may need to be revised until more accurate predictions are achieved.

When valuing an intangible asset, the analyst may postulate a conceptual model from which the observable behavior of market participants may be predicted. The identity of the relevant market participants varies based on the intended standard (or definition) of value. This conceptual model is typically validated by performing three procedures:

1. Postulating a model based on existing experimental observations or measurements.
2. Checking the predictions of the selected model against further observations or measurements.
3. Adjusting or replacing the model as required by the new observations or measurements.

The third of these above-listed procedures leads back to the first procedure, and the valuation model development process continues without end. The criterion for assessing the quality of a valuation model is its ability to reasonably predict economic per-

formance based on the simplest model. In economics jargon, this "simplest model" is also called the most elegant model.

Reasonable Accuracy. No prediction of the market participant's future behavior is either perfectly accurate or perfectly certain. Valuation analysts should be prepared to observe experimental results that will necessitate the adjustment or replacement of the valuation model. Valuation models should predict with reasonable accuracy. The models should also conform to the generally accepted analytical standards and practices.

The development of a valuation model for a particular intangible asset is an iterative process. However, the validation of the model follows the valuation process. Valuation models are never certain, and they are always subject to revision. Typically, each new valuation model includes the successful parts of the older models.

Validation. Valuation models are not proved, they are validated. The process of being *validated* means that the valuation model has made reasonably accurate predictions. In considering the continued application of a previously validated model, the analyst expects that the valuation model will continue to predict as accurately in the future as it has in the past. However, there is no guarantee of any model's continued predictive ability.

The valuation process is a formalization of learning by experience. All analysts who learn by experience are implicitly using this process. The basic premise of any valuation analysis is that the behavior of the relevant market participants is predictable. The intangible asset valuation analysis process seeks to evoke new thinking

A valuation is in many ways the culmination of research into the intangible asset's expected future economic performance.

or reveal new solutions to old problems.

Analysts rarely achieve a perfect valuation model. Rather, the analyst begins the process with the question, "How do I estimate value?" and concludes with the question, "How can I estimate value more accurately?"

Not So Simple—Identifying the Valuation Problem

Identifying the right valuation question is sometimes more difficult than concluding the correct valuation answer. In the intangible asset valuation assignment, the analyst first identifies the central issues to be addressed and plans a strategy for completing the assignment. An inability to complete the intangible asset valuation is usually the result of poor communication between the analyst and the client (or the client's legal counsel) about the objectives of the assignment. Clients who are unfamiliar with the valuation process may not understand how the implementation of the valuation methods may affect the intangible asset value conclusion. Different intangible property types, ownership interests, legal rights and privileges, and intended uses of the valuation can affect both the valuation process and the value conclusion.

The client and the analyst should fully understand and reach agreement on the assignment, preferably in writing, before the valuation analysis begins. This procedure is important because any change in the selected standard of value, premise of value, or valuation date can affect the value conclusion for the subject intangible asset. The identification of the intangible asset valuation problem typically

includes the following documentation procedures:

- A description of the subject intangible asset.
- A description of the asset's property rights.
- A statement of the objective of the valuation assignment.
- A statement of the purpose of the assignment.
- A definition of the appropriate standard of value.
- A statement of the "as of" valuation date.
- A listing of any client-imposed hypothetical assumptions or limiting conditions.

The subject intangible asset property rights include the rights that are legally held, or may be held, by the intangible asset owner/operator. Analysts may estimate the fee simple interest or a partial ownership interest created by the division of the total bundle of ownership rights. Information regarding the subject ownership rights and any subject transaction or financing may be important to the assignment. Depending on the intended standard of value, these factors may affect the data assembled, the analyses performed, and the value concluded.

The sum of the values of the intangible asset partial ownership interests may not equal the intangible asset fee simple interest value. To estimate the value of a partial ownership interest, the analyst typically assesses evidence of the market participants' attitude to such a partial ownership interest. The clear identification of the intangible asset assignment (1) will help inform the analyst of the relevant empirical data and (2) will help the analyst avoid unnecessary and unproductive tangential analyses.

Highest and Best Use

Through the highest and best use (HABU) analysis, the analyst interprets the market forces that influence the intangible asset, and identifies the use upon which the final value estimate is based. The HABU analysis helps the valuation analyst (1) to identify guideline sale or license transactions that may be relevant to the valuation and (2) to identify any obsolescence factors that may affect the intangible asset value and/or its remaining useful life (RUL).

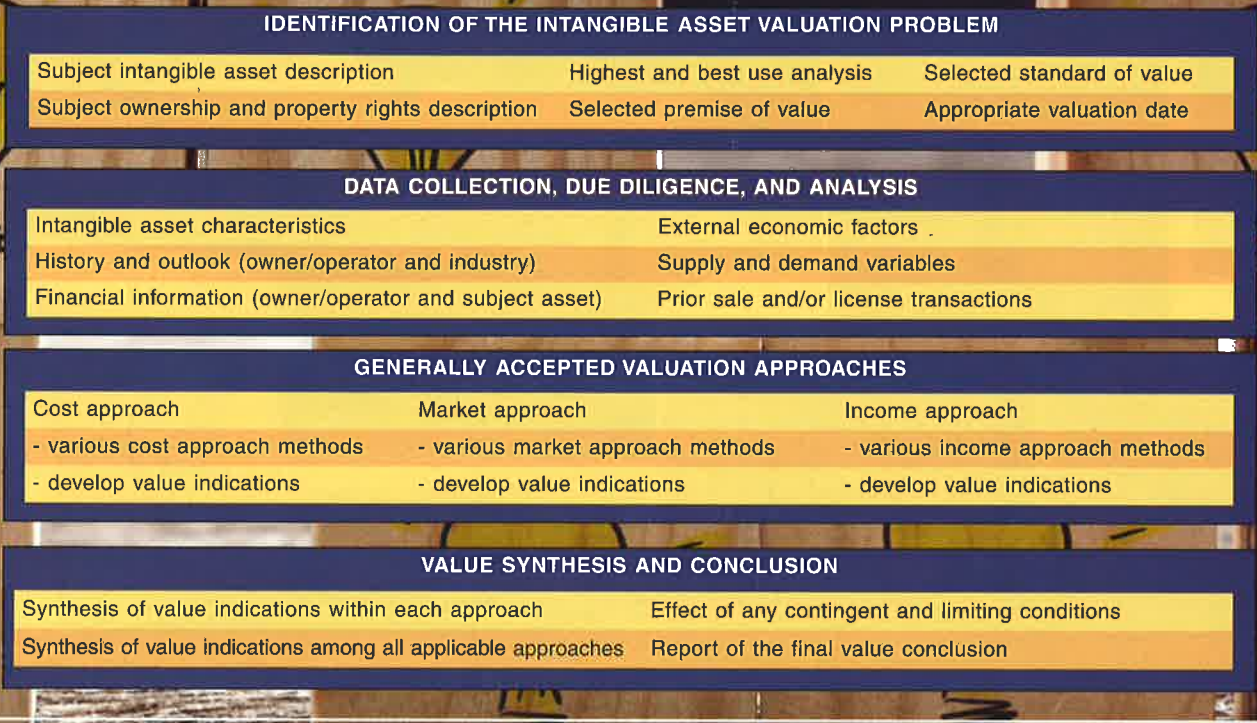
Some of the relevant valuation factors that are identified during the HABU analysis include systematic and non-systematic risk, income projection estimates, and income discount rates or capitalization rates. During the course of the valuation, the analyst may test the sensitivity of the selected valuation variables. Based on this sensitivity analysis, the analyst may conclude a reasonable range of intangible asset values.

The analyst may identify and analyze various owner/operator operating scenarios as part of the HABU analysis. Interrelationships between the selected valuation variable factors in the valuation process—and their probability of occurrence in the future—may be considered. This consideration may also help the analyst to conclude a reasonable range of intangible asset values.

Data Collection and Due Diligence

After defining the valuation problem, the next procedure in the valuation process is data collection and analysis. In performing this procedure, the analyst typically develops the analytical work plan. The analyst gathers, confirms, analyzes, and adjusts empirical data, as appropriate,

EXHIBIT 1
Valuation Process: Principal Component



when performing the intangible asset valuation. Such empirical data typically include:

1. Characteristics of the intangible asset: subject ownership interest, including rights, privileges, conditions, and factors affecting the intangible asset ownership, marketability, or operational control.
2. Nature, history, and outlook of the owner/operator's business and industry.
3. Historical financial information related to the intangible asset development, operations, and license.
4. Any related (or contributory) tangible assets or intangible assets required for the efficient operation of the subject intangible asset.
5. The nature and conditions of any relevant industry that may have an impact on the intangible asset.
6. Local, national, and international economic factors that affect the subject intangible asset.
7. Available rates of return on alternative investments and a description of any relevant market transactions.

8. Prior sale or license (both inbound and outbound) transactions involving the subject intangible asset.
9. Any other relevant information.

The engagement work plan may include an analysis of (1) the market for the intangible asset and (2) the intangible asset's supply and demand relationships. To efficiently complete the intangible asset valuation, the valuation process should be planned and scheduled. Engagement time and staffing requirements vary based on the complexity of the assignment objective and based on the complexity of the available data. Some valuation assignments can be completed in a few days, while other engagements require several months to gather and analyze the relevant data.

Specialists. On some valuation assignments, the analyst may seek the assistance of third-party specialists with expertise in other fields. For example, the valuation of the contract rights associated with the distribution of a particular entertainer's work product may benefit from the opinion of an entertainment industry agent.

The principal analyst is ultimately responsible for the value opinion and the valuation work product. Therefore, the principal analyst should have a clear understanding of the responsibilities of each of the assignment team members. Taking a comprehensive view, the principal analyst will recognize the type, volume, and sequence of all of the work to be performed by each assistant.

The amount and type of empirical data collected may depend on how the valuation assignment is defined. For example, the valuation problem may indicate that one valuation approach be given greater emphasis in the final value estimate. Ultimately, the analyst's assessment of the quality and quantity of available data will determine the applicability of any valuation approach or approaches. The empirical data collected and analyzed affect the judgments made in the intangible asset valuation. Therefore, the intangible asset valuation report typically includes a description of all of the information considered by the analyst.



Generally Accepted Valuation Approaches

The valuation process is applied to develop a well-supported estimate of a defined value, based on consideration of all relevant data. The analyst estimates the intangible asset value after considering the three generally accepted valuation approaches: cost, market, and income. The analyst will select and apply one or more of these generally accepted approaches in developing all estimates of intangible asset value. Which of the three approaches is most applicable in the particular analysis depends on the type of the intangible asset, the intended use of the valuation, and the quality and quantity of empirical data available for analysis.

All three generally accepted valuation approaches are applicable to many intangible asset valuation analyses. Depending on the specific assignment, one or more of the approaches may have greater significance. Where possible, the analyst selects and applies more than one approach. Alternative value indications can serve

as useful benchmarks for assessing the reasonableness of the value indication of the primary valuation approach.

Contingent and Limiting Conditions

It is often necessary for the analyst to make general assumptions in order to carry out the valuation assignment in an efficient manner. General assumptions deal with issues such as legal and title considerations, license terms and conditions, liens and encumbrances, information furnished by other parties (e.g., engineering or market research studies), hidden conditions and environmental hazards, and compliance with applicable laws and regulations.

The analyst will make it clear that the possession and use of the valuation report is limited to the specific purpose and to the specific audience for which it was prepared. Unless otherwise agreed to with the client, the analyst typically has no responsibility to update the valuation report or

to provide further client consultation or litigation expert testimony services.

The intangible asset valuation report is typically based on all the information available to the analyst as of the date of the report. The analyst typically assumes the accuracy of information provided by the client or the client's legal counsel. Even if the analyst is a certified public accountant, the analyst typically will not audit such client-provided information for accuracy. The financial projections that the analyst uses as part of the analysis are typically based on information that is current as of the valuation date. Such financial projections are typically subject to change due to unexpected changes in future economic conditions and market conditions.

The valuation report typically indicates that (1) the analyst personally conducted the valuation and (2) the analyst has no present or prospective interest in the intangible asset. The analyst typically reports that he or she has no personal interest or bias with respect to the parties involved. With regard to

If the predictions are reasonably accurate, then the value conclusion will be supportable.

independent valuations, the report usually specifies that the assignment fee for performing the analysis is not contingent on the value reported or the attainment of a stipulated event. Depending on the professional qualifications of the analyst, the intangible asset value development and valuation report may be prepared in compliance with a specified set of professional standards. Such professional standards may include SSVS, the Uniform Standards of Professional Appraisal Practice (USPAP), or some other organization's professional standards.

Value Conclusion

From an overall engagement perspective, the analyst should consider the question, "Did I accomplish what I set out to accomplish in the intangible asset valuation?" The analyst's final review of the intangible asset valuation assignment should consider:

1. Identification of the subject intangible asset (including the subject ownership interest).
2. The objective of the intangible asset valuation.
3. The purpose of the intangible asset valuation.
4. The subject intangible asset ownership interest (including the specific bundle of legal rights included in the analysis).
5. The date of the value estimate.
6. Definition of the appropriate standard of value to be estimated.
7. Definition of the appropriate premise of value (based on the client's instruction or the analyst's HABU conclusion).

The valuation is typically performed to answer a specific question about the intangible asset value. Even within the same valuation approach,

different methods will typically conclude different value indications. For example, it is likely that different indicated values would result from two different income approach methods (e.g., from the multiperiod excess income method versus from the discounted incremental income method).

Reconciliation. The process of reconciliation involves the analysis of the alternative value indications in order to arrive at an intangible asset final value estimate. Before reaching a final value estimate, the analyst reviews the entire intangible asset valuation for appropriateness and accuracy. It is noteworthy that the definition of value estimated, and its relationship to each procedure in the valuation process, should be carefully considered during the reconciliation process.

Valuation Report

For most assignments, the results of the intangible asset valuation process are typically presented to the client (or to other interested parties) in a valuation report. Such a report may be either an oral report (e.g., expert testimony) or a written report.

Regardless of whether it is prepared in accordance with any specified set of professional standards, the intangible asset valuation report should clearly and accurately set forth the valuation in a manner that is not misleading. The report should contain sufficient information to enable the audience to properly understand it. And, it should disclose any extraordinary assumptions or hypothetical conditions that may affect the intangible asset value conclusion.

The analyst's professional qualifications and experience are typically included in the written valuation

report. Such disclosures are intended to provide evidence of the analyst's competence to perform the subject valuation assignment.

Litigation. In valuation reports prepared for litigation purposes, there may be specific disclosure requirements in order for the analyst's work product to be accepted into evidence as an expert report. Such disclosures may include the analyst's prior expert testimony experience and prior publications, as well as his or her professional qualifications. Analysts who expect to provide expert testimony should confer with the client's legal counsel regarding all applicable expert report form, format, and disclosure requirements.

Conclusion

Understanding the principal procedures in the valuation process—and the underlying reasons for such procedures—helps ensure the successful completion of intangible asset valuation assignments. The valuation process provides a general analytical structure that assists the analyst in the collection, assessment, analysis, and interpretation of market-derived valuation evidence. These procedures provide a logical framework that allows the analyst to synthesize and conclude a reasonable intangible asset value estimate. These methods also assist the analyst in communicating the results of the intangible asset valuation in a well-reasoned and well-supported report.

The most complex intangible asset valuation problem can be more easily understood, and more effectively solved, if the analyst addresses the problem in terms of the above described valuation process. ■