Intangible Asset Valuations for Controversy Purposes

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Discussion Outline

- What is and what is not an intangible asset
- Examples of intangible assets and intellectual property
- Types of intangible asset analyses
- Controversy (and other) reasons to analyze intangible assets
- Intangible asset valuation approaches and methods
- Intangible asset valuation considerations
- Differences between business valuation and intangible asset valuation
- Intangible asset damages measurement methods
- Intangible asset damages measurement considerations
- Valuation and damages report considerations

What is an Intangible Asset?

- It must be an asset, and it must be intangible
- FASB Statement of Financial Accounting Concepts No. 5 (CON 5) provides guidance on what is an asset:
  - It provides probable future economic benefits
  - The owner/operator is able to receive the benefit and restrict others from access to the benefit
  - The event that provide the right to receive the benefit has occurred
- Intangible means something that lacks physical substance
- For an intangible asset, intangible means that the economic benefit of the asset does not come from its physical substance
- Intangible asset value is based on the rights and privileges to which it entitles the owner/operator

Intangible Asset Attributes

- An intangible asset should have the following attributes
  - It is subject to a specific identification and recognizable description
  - It is subject to legal existence and legal protection
  - It is subject to the rights of private ownership, and that private ownership should be transferable
  - There is some tangible evidence or manifestation of the existence of the intangible asset
  - It is created or it comes into existence at an identifiable time or as the result of an identifiable event
  - It is subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event
  - There should be a specific bundle of legal rights associated with the intangible asset

What is Not an Intangible Asset?

- There are intangible attributes or influences that may affect the value of intangible assets (or of a business entity)
- These attributes or influences are not assets
- Examples include:

1. High market share
2. High profitability or high profit margin
3. Lack of regulation
4. A regulated (or protected) position
5. Monopoly position (or barriers to entry)
6. Market potential
7. Breadth of customer appeal
8. Mystique
9. Heritage or longevity
10. Competitive edge
11. Life-cycle status
12. Uniqueness
13. Discount prices (or full prices)
14. Positive image
15. First to market
16. Technological superiority
17. Consumer confidence or trustworthiness
18. Creativity
19. High growth rate
20. High return on investment
21. Size
22. Synergies
23. Economies of scale
24. Efficiencies
25. Longevity

Examples of Intangible Assets: ASC 805

- Marketing-related intangible assets
  - Trademarks, trade names, service marks, collective marks, certification marks
  - Trade dress (unique color, shape, package design)
  - Newspaper mastheads
  - Internet domain names
  - Noncompetition agreements
- Customer-related intangible assets
  - Customer lists
  - Order or production backlogs
  - Customer contracts and related customer relationships
  - Noncontractual customer relationships

Examples of Intangible Assets: ASC 805 (cont.)

- Artistic-related intangible assets
  - Plays, operas, and ballets
  - Books, magazines, newspapers, and other literary works
  - Musical works such as compositions, song lyrics, and advertising jingles
  - Pictures and photographs
  - Video and audiovisual material, including motion pictures or films, music videos, and television programs

Examples of Intangible Assets: ASC 805 (cont.)

- Contract-based intangible assets
  - Licensing, royalty, and standstill agreements
  - Advertising, construction, management, and service or supply contracts
  - Lease agreements (whether the acquiree is the lessee or the lessor)
  - Construction permits
  - Franchise agreements
  - Operating and broadcast rights
  - Servicing contracts such as mortgage servicing contracts
  - Employment contracts
  - Use rights such as drilling, water, air, timber cutting, and route authorities

Examples of Intangible Assets: ASC 805 (cont.)

- Technology-based intangible assets
  - Patented technology
  - Computer software and mask works
  - Unpatented technology
  - Databases, including title plants
  - Trade secrets, such as secret formulas, processes, and recipes

Examples of Intangible Assets: IRC 197

- Internal Revenue Code Section 197 intangible assets include:
  - Goodwill
  - Going concern value
  - Any of the following intangible items:
    - workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment;
    - business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers);
    - any patent, copyright, formula, process, design, pattern, knowhow, 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 an agency or instrumentality thereof

Examples of Intangible Assets: IRC 197 (cont.)

- Internal Revenue Code Section 197 intangible assets include: (cont.)
  - Any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not t o compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof
  - Any franchise, trademark, or trade name

Types of Intellectual Property

- There are four types of intellectual property
  - Patents
  - Trademarks
  - Copyrights
  - Trade secrets

Types of Intangible Asset Analyses

- Valuation
- Damages analysis
- Transfer price analysis
- Fairness opinion
- Solvency/insolvency analysis
- Private inurement opinion
- License royalty rate analysis
- Exchange ratio analysis

Categories of Reasons to Analyze Intangible Assets

- Transaction pricing and structuring
- Financing securitization and collateralization
- Federal and state tax planning and compliance
- Management information and strategic planning
- Bankruptcy and reorganization
- Forensic analysis and dispute resolution
- Intercompany use and ownership transfers
- Financial accounting and fair value reporting
- Corporate governance and regulatory compliance
- License, joint venture, development opportunities

Forensic Valuation and Damages Analyses

- Within a controversy context, most intangible asset valuations are performed for purposes of:
  - taxation disputes
  - shareholder disputes
  - family law disputes
- Within a controversy context, most intangible asset damages analyses are performed for purposes of:
  - breach of contract claims
  - tort claims
- Within a controversy context, most intangible asset transfer price analyses are performed for purposes of:
  - income taxation (federal and state) disputes
  - property taxation disputes
  - shareholder oppression claims

Intangible Asset
Breach of Contract Claims

- Examples of contracts involving intangible assets include:
  - Employment agreements
  - Noncompetition agreements
  - Nonsolicitation agreements
  - Advertising and other promotion agreements
  - Product placement agreements
  - Supply agreements
  - Customer or client purchase contracts
  - Loan indentures
  - Leases
  - Use licenses and other intellectual property licenses
  - Franchise agreements
  - Construction contracts
  - Intellectual property commercialization or development agreements
  - Joint venture agreements
  - Procurement contracts
  - Entire-output contracts
  - Marine or other shipping contracts
  - Take-or-pay contracts
  - Marketing contracts
  - Contracts to sell
  - Intercompany intangible property transfer agreements
  - Intercompany intangible property license agreements

Intangible Asset Tort Claims

- Examples of tort claims involving intangible assets include:
  - interference with business relationship
  - interference with business opportunity
  - interference with contractual rights
  - infringement
  - disparagement or defamation
  - accounting fraud and misrepresentation
  - condemnation and eminent domain
  - breach of fiduciary duty
  - breach of agency duty
  - lender liability
  - shareholder oppression (the noncontrolling shareholder of controlled licensee)

Intangible Asset Valuation or Damages – Bundles of Legal Rights

- Fee simple
- Term interest
- Life interest
- Residual/reversionary interest
- Licensor or franchisor interest
- Licensee or franchisee interest
- Sub-license or sub-franchisee rights
- Development rights
- Exploitation rights
- Commercialization rights
- Use rights – territorial/geographic
- Use rights – product/industry rights

Considerations Related to Bundles of Legal Rights

- Intangible asset/intellectual property type
- Term(s) of the transfer
- Territory of the transfer
- Products/services covered
- Ability to sublicense
- Ability to modify
- Exclusive/nonexclusive use
- Ability to assign
- Development responsibility
- Commercialization responsibility
- Maintenance responsibility
- Legal protection/prosecution responsibility
- Registration responsibility
- Regulatory responsibility
- Minimum sales activity
- Minimum promotion activity

Intangible Asset Valuation Considerations

- What intangible asset is the valuation subject?
- What intangible asset rights are included in the valuation?
- What is the appropriate standard of value?
- What is the appropriate premise of value?
- What is the appropriate valuation date(s)?
- Who is the intended audience for the valuation?
- What is the appropriate type of report?

Generally Accepted Intangible Asset Valuation Approaches and Methods

- Cost approach methods
  - Reproduction cost new less depreciation method
  - Replacement cost new less depreciation method
  - Trended historical cost less depreciation method
- Market approach methods
  - Relief from royalty method
  - Comparable uncontrolled transactions method
  - Comparable profit margin method
- Income approach methods
  - Differential income (with/without) method
  - Incremental income method
  - Profit split method (or residual profit split method)
  - Residual (excess) income method)

Intangible Asset Cost Approach Valuation Components

- All cost approach methods include a current cost measurement and a depreciation measurement
- Four cost components
  - Direct costs (direct materials and direct labor)
  - Indirect costs (overhead and administrative expenses)
  - Developer's profit (on the direct and indirect costs)
  - Entrepreneurial incentive (opportunity cost—or lost income—during the replacement period)
- Three depreciation components
  - Physical depreciation (not a significant factor)
  - Functional/technological obsolescence (consider the intangible asset RUL)
  - Economic/external obsolescence (consider the intangible asset ROI)

Intangible Asset Cost Approach Valuation Components (cont.)

- Typical cost approach valuation formula

	Replacement cost new
less	Functional obsolescence
less	Technological obsolescence
less	Economic/external obsolescence
equals	Value

- Cost approach valuation considerations
  - All cost components (including opportunity cost) included in the measurement
  - Treatment of excess capital (development) costs and excess operating costs
  - Consideration of the intangible asset RUL
  - Consideration of owner/operator economic obsolescence

Intangible Asset Market Approach Valuation Components

- Pricing metrics are based on either comparable or guideline:
  - licenses of intangible assets
  - sales of intangible assets
  - companies that use intangible assets
- Market approach valuation variables and procedures
  - Quantitative/qualitative analysis of the subject intangible asset
  - Guideline license/sale/company selection criteria
  - Guideline license/sale/company selection
  - CUTs are comparable and uncontrolled and transactions
  - Verification of the selected transactional data
  - Analysis of the selected transactional data
  - Selection of the appropriate pricing metrics
  - Selection of subject-specific pricing multiples
  - Application of the selected pricing multiples to the subject intangible asset metrics

Intangible Asset Market Approach Valuation Components (cont.)

- Market approach valuation considerations
  - Seasoned guideline intangible asset/development stage subject intangible asset
  - Development stage guideline intangible asset/seasoned subject intangible asset
  - Term of license agreements/life of subject intangible asset
  - Exclusivity/other rights of license agreements/rights of subject intangible asset
  - State of the competition in the owner/operator industry
  - Comparable profit margins—is the subject intangible asset the only reason for the difference in profit margins between the owner/operator company and the selected CPM companies?

Intangible Asset Income Approach Valuation Components

- Common intangible asset income concepts include:
  - incremental (or differential) owner/operator revenue
  - decremental owner/operator expense
  - decremental owner/operator investment
  - decremental risk to the owner/operator
- Common intangible asset income measures include:
  - EBITDA
  - EBIT
  - NOI (EBITDA less income taxes)
  - Net income
  - Net cash flow

Intangible Asset Income Approach Valuation Components (cont.)

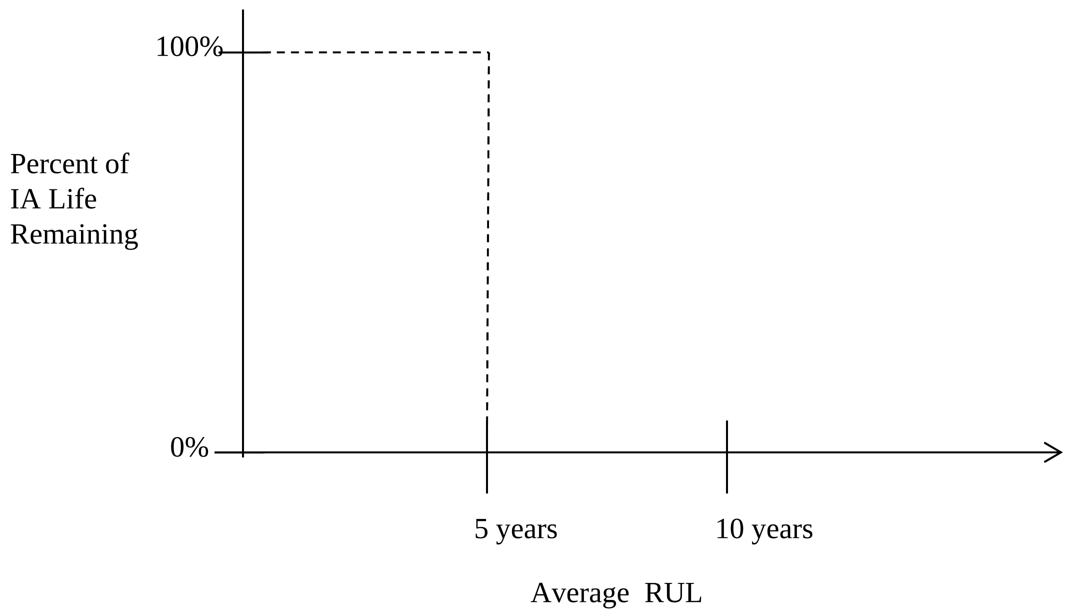
- Income approach valuation formula
  - Yield capitalization methods, based on a nonconstant growth income projection
    - over a finite RUL projection period
    - over a finite RUL projection period with a terminal value
  - Direct capitalization methods, based on a constant growth income projection
    - over a finite RUL projection period
    - over a perpetuity projection period

Intangible Asset Income Approach Valuation Components (cont.)

- Income approach valuation considerations
  - Match the selected discount/capitalization rate with the selected income measure
  - Match the selected discount/capitalization rate with the subject intangible asset risk
  - Consider the state of the competition in the owner/operator industry
  - Consider all subsequent (to the valuation date) capx, R&D expenses, marketing expenditures, etc.
  - Analyze only the income that is directly related to the subject intangible asset
  - Consider the applicability of the tax amortization benefit (TAB) adjustment
  - Present value the projected income over either:
    - the intangible asset average RUL
    - down the intangible asset RUL decay curve

Intangible Asset Income Approach Valuation Components (cont.)

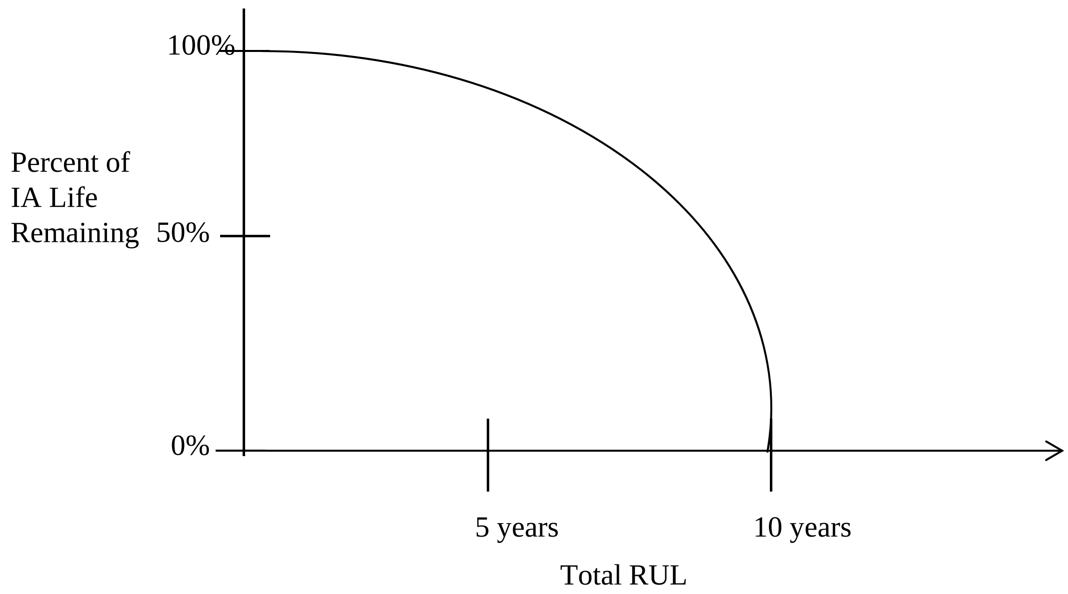
Present Value of Income Projection
Over the Average Remaining Useful Life



Assumes: IA Total Remaining Life of 10 Years
IA Average Remaining Useful Life of 5 Years

Intangible Asset Income Approach Components (cont.)

Present Value of Income Projection
Down the Total Remaining Useful Life Curve



Assumes: IA Total Remaining Life of 10 Years
IA Average Remaining Useful Life of 5 Years
Consider the Shape of the IA Life Cycle and the IA RUL

Intangible Asset Valuation Synthesis and Conclusion

- The synthesis and conclusion is the last procedure in the valuation process
- The analyst typically performs a valuation reconciliation procedure related to the alternative value indications
- The analyst answers the following questions:
  - Did I value the right thing? That is, did I analyze the correct intangible asset?
  - Did I value the right thing the right way? That is, did I apply the appropriate valuation approaches, methods, and procedures?
  - Did I reach the right value conclusion? That is, did I correctly apply the valuation procedures that I performed in order to reach a reasonable and supportable value estimate?
  - Did I do what I intended to do? That is, did I perform the assignment that I set out to perform? Did I achieve the purpose and objective of the assignment?

Differences between Business Valuation and Intangible Asset Valuation

- Different highest and best use considerations (HABU)
  - Business valuation HABU almost always value in use
  - Intangible asset valuation HABU may vary
- Income approach considerations
  - Business value based on 100% of entity income
  - Intangible asset value based on an identified portion of entity income
  - Business value based on perpetuity assumption
  - Intangible asset value often based on finite RUL
  - Business value based on lower risk (lower discount/cap rate)
  - Intangible asset value often based on higher risk (higher discount/cap rate)
  - Business value typically ignores asset revaluation tax issues

Differences between Business Valuation and Intangible Asset Valuation (cont.)

- Income approach considerations (cont.)
  - Intangible asset value often considers asset revaluation tax issues
  - Business value long-term growth rate is almost always positive
  - Intangible asset value long-term growth rate is often negative (over finite RUL)
  - Business value maintenance expenses are commonly considered in the income approach analysis: capx, working capital additions, R&D expenses
  - Intangible asset value maintenance expenses should be considered in any income approach analysis: legal protection, R&D expense, advertising & promotion expense, etc.

Differences between Business Valuation and Intangible Asset Valuation (cont.)

- Market approach considerations
  - Different transactional databases
  - Different type of sale/license transactions
  - Different pricing metrics
  - Different analyst due diligence considerations
- Cost approach considerations
  - The cost approach is not the asset-based approach
  - The cost approach typically measures the intangible asset going-concern value
  - The asset-based approach typically measures the business entity going-concern value

The Cost Approach is Not the Asset-Based Approach

- The cost approach is used to value individual tangible and intangible assets
  - So it is a generally accepted approach to value intangible assets
  - It may be used to value the subject company tangible and intangible assets as part of the asset-based approach
  - The cost approach is not a business valuation approach
  - The cost approach may be used to value assets on a going-concern basis (it typically does not conclude a liquidation value)

The Cost Approach is Not the Asset-Based Approach (cont.)

- The asset-based approach is a business valuation approach
  - The asset-based approach is based on the company balance sheet (and not on the income statement)
  - The asset-based approach involves the revaluation of all of the company assets (both tangible and intangible) either:
    - individually – the asset accumulation method or
    - collectively – the adjusted net asset value method
  - The asset-based approach values the company asset categories based on either:
    - the income approach to asset appraisal
    - the market approach to asset appraisal
    - the cost approach to asset appraisal

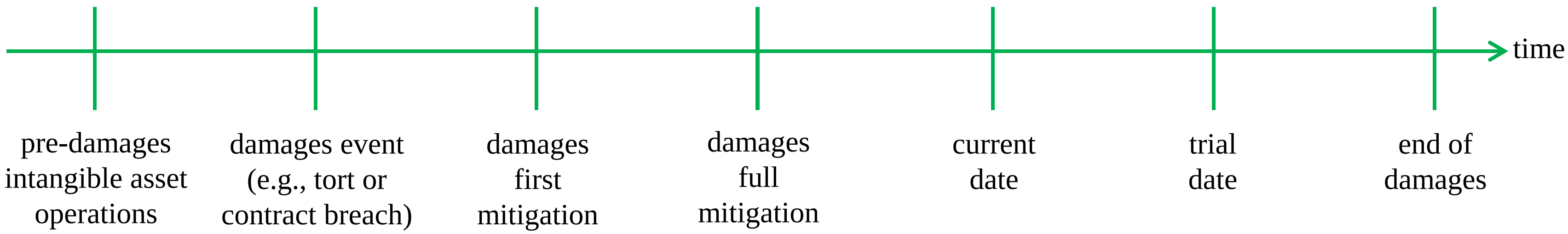
The Cost Approach is Not the Asset-Based Approach (cont.)

- Typically, in an asset-based approach analysis, at least one intangible asset is valued using an income approach method, such as:
  - the multiperiod excess earnings method (MEEM) or
  - the capitalized excess earnings method (CEEM)
- The asset-based approach does conclude a going-concern value indication. Adjustments have to be made to the asset-based approach analysis to indicate a liquidation value; such adjustments include:
  - exclusion of most (or all) intangible assets
  - liquidation values of tangible assets
  - adjustment for income tax liability on asset disposition
  - adjustment for business wind-down operating expenses
  - adjustment for time value of money during asset disposition period

Intangible Asset Damages Considerations

- What is the intangible asset subject to damages?
- What are the intangible asset bundle of rights subject to damages?
- What is the damages event?
- What are the damages event dates/periods?
- What is the appropriate legal definition of the subject damages?
- Should I use any legally determined damages variables?
- Should I analyze mitigation?
- What should I assume about causation and liability?
- Are there any legally allowed or legally disallowed damages methods?
- Is the objective of the analysis to conclude:
  - the damages amount to the damaged party, or
  - the recommended judicial award to the damaged party?
  - In other words, should I consider the income tax impact of the judicial award to the damaged party?
- What is the appropriate type of report?
- Who is the intended audience for the damages analysis?

Intangible Asset Damages Analysis Dates



Generally Accepted Intangible Asset Damages Methods

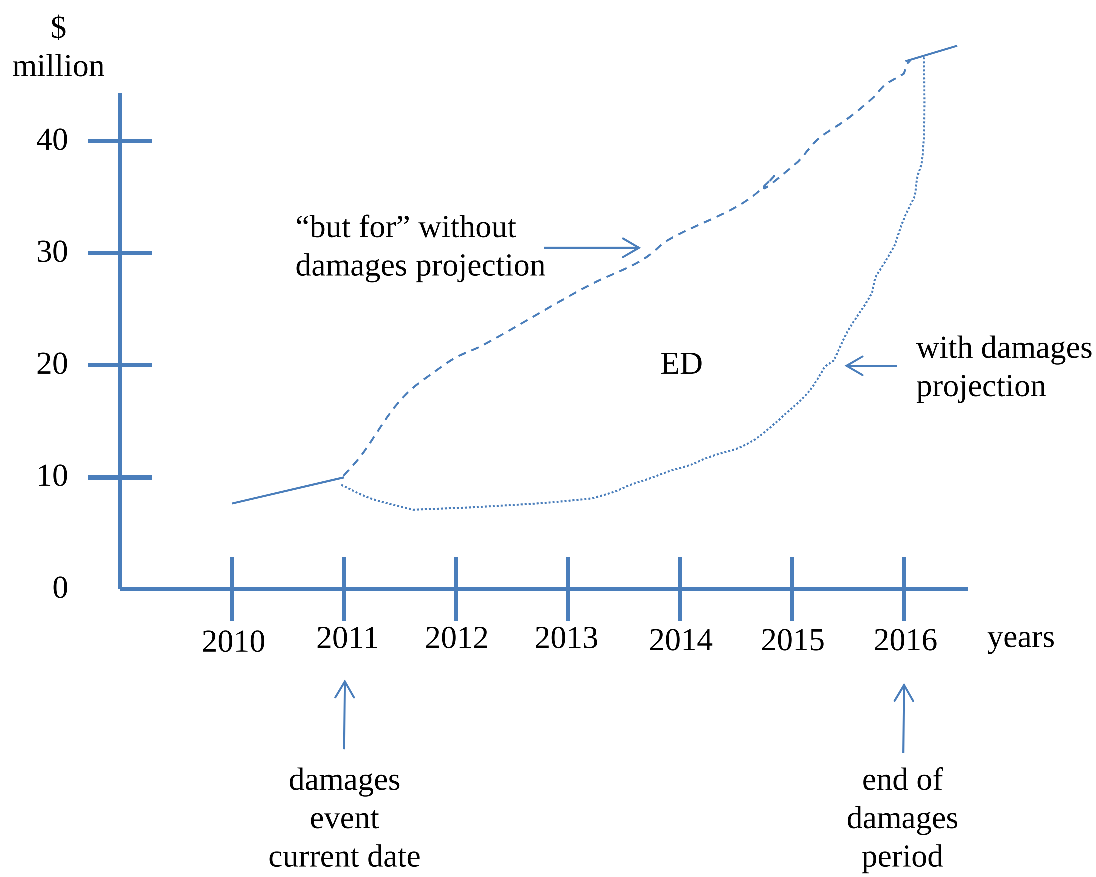
- The common intangible asset damages measurement methods include:
  - lost profits methods
  - lost value or cost to cure methods
  - reasonable royalty rate methods
- There may be other legally permitted damages measurement methods, such as:
  - unjust enrichment methods
  - statutory damages amounts

Lost Profits Damages Methods

- The three common lost profits damages measurement methods include:
  - The projections method
  - The yardstick method
  - The before and after method
- Lost profits measurement method considerations
  - What is the appropriate damages period?
  - What is the appropriate measure of income?
  - What is the appropriate present value discount rate?
  - Do I apply ex ante or ex poste damages measurement calculations?
  - Do I include lost profits on indirect or convoyed product sales?

Lost Profits Methods

Lost Profits Damages
Projections Method
Contribution Margin Measure of Profits



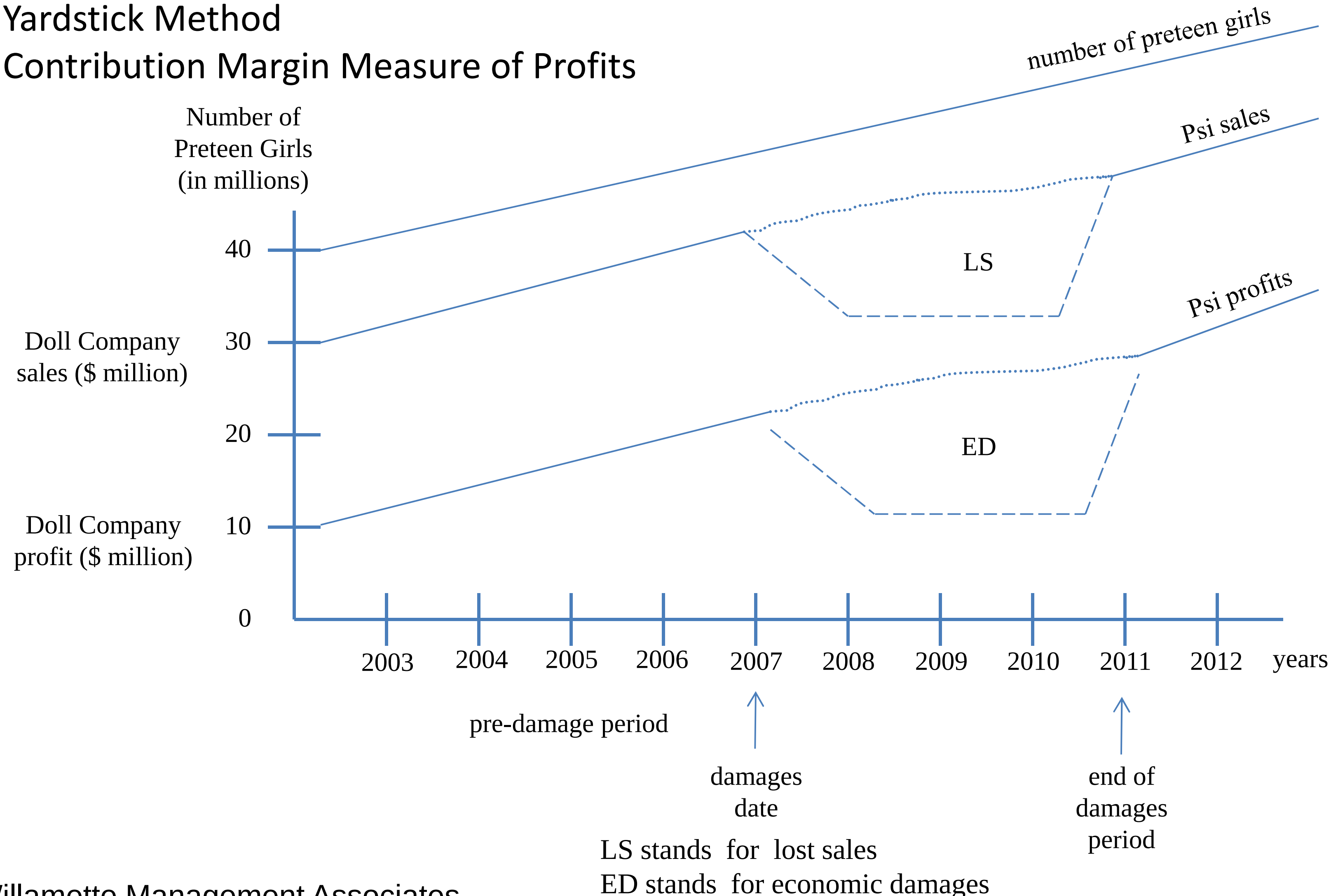
ED stands for economic damages

Lost Profits Methods

Lost Profits Damages

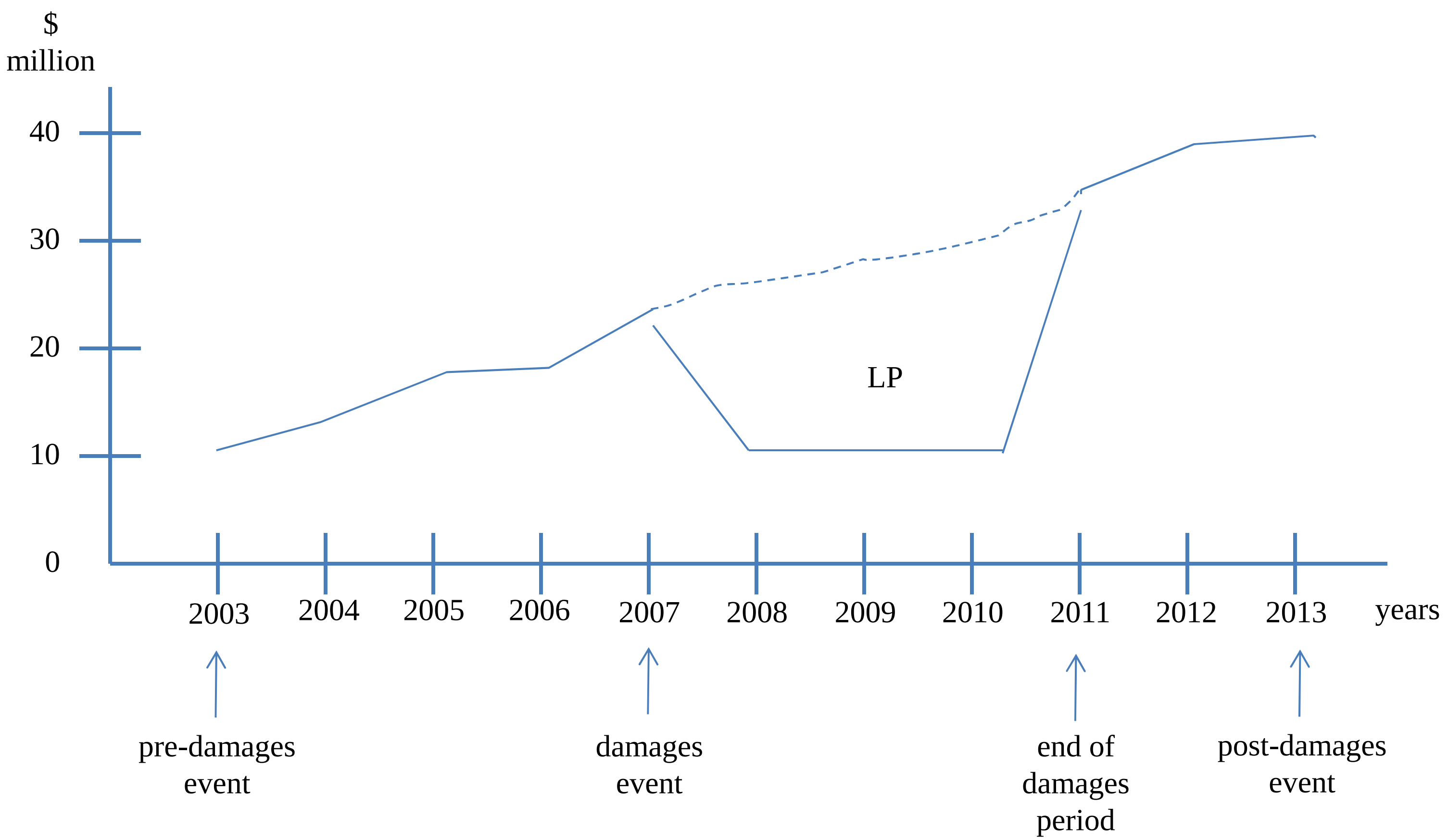
Yardstick Method

Contribution Margin Measure of Profits



Lost Profits Methods

Lost Profits Damages
Before and After Method
Contribution Margin Measure of Profits



LP stands for lost profits

Lost Value of Cost to Cure Damages Methods

- Estimate the intangible asset value before the damages event versus the intangible asset value after the damages event
- Estimate the intangible asset value with the damages event versus without the damages event
- What is the appropriate standard of value to measure the cost to cure damages?
- The generally accepted intangible asset valuation approaches apply
  - cost approach
  - income approach
  - market approach

Reasonable Royalty Rate Damages Methods

- The four common intangible asset reasonable royalty rate estimation methods include:
  - The investment method
  - The income method
  - The comparable uncontrolled transaction method
  - The comparable profit margin method

The Damages Award as a Taxable Event

Recommended Judicial Award
Income Tax Adjustment to Actual Damages

Factor	Recommended Judicial Award Component	Amount
1.	Estimate of injured party intangible asset actual damages (based on any damages measurement method)	$10,000,000
2.	Estimate of income tax adjustment on the compensatory damages (1 – assumed 35% income tax rate)	+ 65%
3.	Recommended total judicial award required to restore the claimant to its financial condition before the damages event	$15,385,000

Income Tax on Recommended Judicial Award
Reconciliation to Actual Damages

Factor	Actual Damages Reconciliation Component	Amount
1.	Assume the finder of fact orders the recommended total award (i.e., taxable income to the claimant)	$ 15,385,000
2.	Income tax expense related to the judicial award (at the 35% income tax rate)	5,385,000
3.	Reconciliation to injured party intangible asset actual damages	$ 10,000,000

Intangible Asset Valuation or Damages Report

- In order to encourage the reader's acceptance, the effective intangible asset valuation or damages report should be:
  - clear, convincing, and cogent
  - well-organized, well-written, and well-presented
  - free of grammar, punctuation, spelling, and mathematical errors
  - procedurally and mathematically replicable, without the use of any unexplained or unsourced valuation/damages variables

Intangible Asset Valuation or Damages Report (cont.)

- The persuasive intangible asset valuation or damages report will tell a narrative story that:
  - defines the analyst's assignment
  - describes the analyst's data gathering and due diligence procedures
  - justifies the analyst's selection of—and rejection of—(a) the generally accepted valuation approaches, methods, and procedures and (b) generally accepted damages measurement methods
  - explains how the analyst performed the valuation/damages synthesis and reached the final value/damages conclusion
  - defends the analyst's intangible asset value/damages conclusion
  - describes all of the data sources that the analyst relied on (and includes copies of nonpublic source documents)

Intangible Asset Valuation or Damages Report (cont.)

- Finally, do not ignore AICPA (or other relevant) professional standards:
  - SSVS for intangible asset valuations
  - SSCS for intangible asset damages analyses
  - there may be litigation-related reporting standards exceptions—but not valuation or damages analysis exceptions

Summary and Conclusion

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