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Valuation of Intangible Assets in Family Law Cases: Part I of III

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This three-part article discusses the valuation of intangible assets in Family Law cases. Part I covers business combination accounting, intangible asset attributes and categories, and the valuation assignment and analysis. Part II will discuss valuation approaches and methodologies (cost, market, income). Part III will turn to income and cost approach examples, common databases, and errors to avoid.

This article focuses on the recognition and valuation of identifiable intangible assets for family law purposes. There are several instances when an intangible asset valuation may be relevant within a family law context. First, the marital estate may own intangible assets (such as intellectual property) directly. Second, the marital estate may have an ownership interest in a closely held business or professional practice. In the asset-based business valuation approach, the value of a business or practice depends, in part, on the value of its intangible assets. Third, the value of the business or practice may depend on intangible assets that were created or contributed before the date of the marriage. Or, the value of the business or practice may depend on intangible assets that were created or contributed by one spouse or the other during the marriage. Fourth, the business or practice intangible assets may serve as a device to achieve a distribution of assets in a marital dissolution. That is, one spouse could own the business or practice equity. That business could distribute its intangible assets to the other spouse. The distributee spouse would enter into a license agreement, licensing the use of the distributed intangible asset back to the operating business. That license would provide income and wealth to the distributee spouse. Under this arrangement, the business/practice ownership interest would not need to be divided among the marital parties in order to achieve a fair distribution of the marital assets.

Under certain limited circumstances, identifiable intangible assets are valued and recorded for U.S. generally accepted accounting principle (GAAP) compliance purposes. This article summarizes the generally accepted procedures used to value identifiable intangible assets for GAAP financial reporting purposes. It also considers how those procedures may inform marital parties (parties), family law counsel (counsel), and valuation

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analysts (analysts) who have to recognize and value intangible assets as part of a family law matter.

BUSINESS COMBINATION ACQUISITION ACCOUNTING

Under GAAP, guidance regarding an acquirer's business combination is provided by the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) topic 805, *Business Combinations*. Under ASC 805, the acquirer accounts for a business combination under what is called the acquisition method of accounting. Experienced analysts recall the now-obsolete GAAP term "purchase method" of accounting. Several years ago, the FASB changed the previous terminology "purchase method" (and the FASB also changed many of the technical accounting procedures) to the current terminology "acquisition method." The reason for this terminology change was to emphasize that, under ASC 805, a business combination transaction occurs in a change of control event—even when a merger or acquisition purchase transaction is not involved.

Inexperienced analysts sometimes ask: Why can't I simply rely on the value of the intangible assets as reported on the family-owned company's GAAP-based financial statements? The answers to that question are twofold.

First, under ASC 805, identifiable intangible assets are only recorded on an entity's financial statements after a change of control event. That is, only intangible assets acquired as part of a change of control transaction are reported on an entity's financial statements. Unless the family-owned company was acquired, its intangible assets would not be recorded under GAAP. Internally created (i.e., not acquired in an acquisition) intangible assets are almost never reported under GAAP. If the family-owned company makes an acquisition, the acquired intangible assets are recorded. The family company/acquirer's intangible assets are, however, still not reported under GAAP.

Second, as described below, identifiable intangible assets acquired in a business combination are reported at the fair value standard of value. For family law purposes, many jurisdictions include marital estate assets at fair market value—or some conceptually similar standard of value. Depending on the jurisdiction-specific statutory authority, judicial precedent and administrative rulings, GAAP fair value and family law fair market value may—or may not—be sufficiently similar standards of value.

ASC topic 805 contains six primary subtopics:

1. ASC 805-10 *Overall* (general acquisition method guidance)
2. ASC 805-20 Identifiable Assets and Liabilities, and Any Noncontrolling Interests
3. ASC 805-30 Goodwill or Gain from Bargain Purchase, including Consideration Transferred
4. ASC 805-40 Reverse Acquisitions
5. ASC 805-50 *Related Issues* (including asset acquisitions and transactions between controlled entities)
6. ASC 805-740 *Income Taxes*

This discussion focused on the GAAP acquisition accounting provisions related to identifiable intangible assets. It considered how this GAAP acquisition accounting provisions provide any practical guidance for analysts trying to identify and value intangible assets within the context of a family law valuation. An initial consideration for both GAAP valuation and family law valuation purposes is: What is an identifiable intangible asset?

WHAT IS AN INTANGIBLE ASSET?

Often, an initial issue in an ASC 805 acquisition accounting analysis is the identification of the acquired intangible assets. Typically, it is relatively easy for the analyst to identify the acquired financial assets and tangible assets. The financial assets are recorded on the acquiree company's financial statements. The analyst can physically see the acquiree company real estate and tangible personal property. In contrast, the acquired intangible assets are typically not recorded on the acquiree company financial statements. The analyst often has to search for the physical manifestation (*e.g.*, a contract or a license or a listing) of the acquired intangible assets.

Also, even the acquirer company management may not be sure of exactly what acquiree company intangible assets were acquired. In fact, many acquirer company executives (and the acquiree company executives) may not be sure of exactly what an intangible asset is. Analysts may use the following criteria to help identify the acquired intangible assets in a business combination: (1) it should be an asset and (2) it should be intangible. So, how does the analyst apply these two obvious criteria?

The analyst may search for a physical manifestation (e.g., a contract).

First, the FASB Statement of Financial Accounting Concepts No. 6 (CON 6) Elements of Financial Statements, provides guidance on what is an asset:

1. An asset must provide probable future economic benefits,
2. The owner/operator must be able to receive the benefit of the asset and restrict others from access to that benefit and
3. The event that provide the right to receive the benefit from the asset has already occurred.

Second, the word "intangible" means something that lacks physical substance. For an intangible asset, the intangible criterion means that the economic benefit of the asset does not come from its physical substance. Rather, the intangible asset value is based on the rights and privileges to which that intangible asset entitles the owner/operator.

INTANGIBLE ASSET ATTRIBUTES

For acquisition accounting purposes, the analyst may consider that an intangible asset should have certain attributes. The analyst identifying intangible assets as part of a family law valuation may also look for these attributes:

- It is subject to a specific identification and a 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 legally transferable
- There is some tangible evidence or tangible manifestation of the existence of the intangible asset
- It was created or it came 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 its 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

As explained below, the attribute that the intangible asset ownership should be transferable should not be confused with the requirement that the intangible asset should be able to be sold separately or independently from any of the other target company assets. There is no "sold separately from other assets" criterion for the recognition of an identifiable intangible asset under ASC 805. In fact, the ASC 805-20-55-2 separability criterion (described next) specifically allows for the intangible asset ownership interest to be transferred (1) with another asset—tangible or intangible—or (2) with a liability.

IDENTIFIABLE INTANGIBLE ASSETS

Under ASC 805, an acquirer will recognize separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is considered to be identifiable if it meets either the ASC 805-20-55 (1) separability criterion or (2) contractual-legal criterion.

The economic benefit does not come from the asset's physical substance.

For acquisition accounting purposes, an intangible asset is considered to be identifiable if it meets either of the following two ASC 805-20-55-2 criteria:

- The intangible asset is separable, that is, capable of being separated or divided from the entity that holds it and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the acquirer intends to do so.
- The intangible asset arises from contractual or other legal rights, regardless of whether

those rights are transferable or separable from the acquiree or from other rights and obligations of the acquiree.

These two criteria for identifiable intangible assets are called (1) the separability criterion and (2) the legal/contractual criterion. These two criteria may also provide authoritative guidance for purposes of identifying intangible assets within a family law valuation.

CATEGORIES OF IDENTIFIABLE INTANGIBLE ASSETS

ASC 805-20-55 provides a list of intangible assets that the FASB considers to have the characteristics to meet at least one of the two above-listed criteria to be an identifiable intangible asset. The following are the ASC 805-20-55-13 categories of identifiable intangible assets:

- Marketing-related intangible assets
- Customer-related intangible assets
- Artistic intangible assets
- Contract-related intangible assets
- Technology-related intangible assets

According to ASC 805, goodwill is also an intangible asset. The FASB has however determined that goodwill is not considered an identifiable intangible asset

Marketing-Related Intangible Assets

ASC 805-20-55-14 through 19 provide the following nonexhaustive examples of marketing-related intangible assets:

- Newspaper mastheads
- Trademarks, service marks, trade names, collective marks, and certification marks
- Trade dress
- Internet domain names
- Noncompetition agreements

Customer-Related Intangible Assets

ASC 805-20-55-20 through 28 provide the following nonexhaustive examples of customer-related intangible assets:

- Customer lists
- Customer contracts and related customer relationships
- Noncontractual customer relationships
- Order or production backlogs

Artistic-Related Intangible Assets

ASC 805-20-55-29 provides the following nonexhaustive examples of artistic-related intangible assets:

- Plays, operas, ballets
- Books, magazines, newspaper, and other literary works
- Musical works such as composition, song lyrics, and advertising jingles
- Photographs, drawings, and clip art
- Audiovisual material including motion pictures, music videos, television programs

Contract-Related Intangible Assets

ASC 805-20-55-31 through 37 provide the following nonexhaustive examples of contract-based intangible assets:

- License, royalty, standstill agreements
- Advertising contracts
- Lease agreements
- Construction permits
- Construction contracts
- Construction management, service, or supply contracts
- Broadcast rights

- Franchise rights
- Operating rights
- Use rights
- Servicing contracts
- Employment contracts

Technology-Related Intangible Assets

ASC 805-20-55-38 provides the following nonexhaustive examples of technology-based intangible assets:

- Patented or copyright software
- Mask works
- Unpatented technology
- Databases
- Trade secrets

Under FASB, goodwill is not an identifiable intangible.

WHAT IS NOT AN INTANGIBLE ASSET?

Analysts should be aware that there are intangible attributes or intangible influences that may affect the value of the intangible assets. These attributes or influences are, however, not, themselves, assets. These attributes or influences may explain the reasons why the acquirer company purchased the acquiree company. Acquirer company executives may even believe that these attributes or influences are, in fact, intangible assets. The analyst should however be aware that these otherwise valid reasons for consummating the corporate acquisition do not meet the above-described CON 6 criteria for recognition as an asset.

Examples of intangible attributes or intangible influences—that do not qualify as intangible assets—include the following:

- High market share
- High profitability or high profit margin
- Lack of regulation
- A regulated (or protected) position
- Monopoly position (or barriers to entry)
- Market potential
- Breadth of customer appeal
- Mystique
- Heritage
- Competitive edge
- Life-cycle status
- Uniqueness
- Discount prices (or full prices)
- Positive image
- First to market
- Technological superiority
- Consumer confidence or trustworthiness
- Creativity
- High growth rate
- High return on investment
- Size
- Synergies
- Economies of scale
- Efficiencies
- Longevity

DIFFERENCES BETWEEN TANGIBLE ASSETS AND INTANGIBLE ASSETS

The tangible elements of an intangible asset (*e.g.*, a listing of the computer software source code) do not convert that intangible asset into a tangible asset. The analyst should realize that the important economic difference between a tangible asset and an intangible asset is this:

- The value of a tangible asset is derived from its tangible nature, while
- the value of an intangible asset is derived from its intangible nature.

That is, the value of a tangible asset comes from the owner's use of the physical elements of the asset. The value of an intangible asset comes from the legal or contractual rights associated with the ownership of the intangible asset.

FAIR VALUE GUIDANCE RELATED TO INTANGIBLE ASSET VALUATION

A description of all of the GAAP guidance related to fair value accounting and valuation is beyond the scope of this discussion. This discussion focuses on the valuation of intangible assets. Analysts who perform family law valuations, however, may also be interested in the following GAAP-related valuation guidance:

- FASB ASC topic 820 Fair Value Measurement
- FASB ASC topic 805 Business Combinations
- FASB ASC topic 350 Intangibles – Goodwill and Other
- FASB ASC topic 360 Plant, Property, and Equipment
- FASB ASC topic 718 Compensation – Stock Compensation
- FASB ASC topic 852 *Reorganizations*

OTHER NONAUTHORITATIVE GUIDANCE RELATED TO INTANGIBLE ASSET VALUATION

Three valuation professional organizations (VPOs) have developed a new professional credential related to valuations performed for GAAP-related fair value accounting compliance purposes. These three VPOs are the American Institute of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA), and the Royal Institute of Chartered Surveyors (RICS). The name of the new fair-value-related valuation credential is Certified in Entity and Intangible Valuations (CEIV). A description of the CEIV credential program is beyond the scope of this article. Analysts who value intangible assets within the context of a family law valuation, however, may want to learn more about the requirements for the CEIV credential.

> *Value comes from rights associated with ownership.*

The three VPOs have also issued nonauthoritative guidance related to the fair value valuation of intangible assets for GAAP compliance purposes. This nonauthoritative guidance is an integral part of the training and the testing related to the CEIV credential program. In fact, CEIV credential holders are required to comply with the provisions of this professional guidance. In addition, the three VPOs recommend that the provisions of this professional guidance be considered as best practices for all fair-value-related valuations. Therefore, even analysts who value intangible assets for family law purposes but who are not CEIV credential holders may want to be familiar with this guidance. The two sets of nonauthoritative professional guidance issued by the three VPOs follows:

- Mandatory Performance Framework (MPF) for the Certified in Entity and Intangible Valuations Credential
- Application of the Mandatory Performance Framework (AMPF) for the Certified in Entity and Intangible Valuations Credential

Again, consideration of the specific contents of the MPF and the AMPF are beyond the scope of this article. Copies of both the MPF and the AMPF are available from any of the three VPOs. Analysts who value intangible assets for family law purposes may want to become familiar with the recommended best practices guidance provided in the MPF and the AMPF. Particularly with regard to analyst due diligence procedures, work paper documentation, and report documentation, the following discussion is consistent with the professional guidance provided in the MPF and the AMPF.

DEFINING THE INTANGIBLE ASSET VALUATION ASSIGNMENT

Documenting the analyst's understanding of the assignment is an important procedure in the intangible asset valuation for either acquisition accounting or family law purposes. As indicated in the MFP, there are two components to the intangible asset valuation assignment:

- The objective of the analysis
- The purpose of the analysis

Each of these two assignment components is summarized below.

THE OBJECTIVE OF THE VALUATION ANALYSIS

As indicated in the MPF, the objective of the analysis describes what the valuation is intended to do. The objective of the valuation analysis describes the following:

- The specific intangible asset(s) that is (are) the subject of the valuation
- The ownership interest (or the bundle of legal rights) that is the subject of the valuation
- The standard of value and the premise of value being estimated
- The "as of" acquisition date or valuation date

ASC 820, *Fair Value Measurements*, provides a definition of fair value. ASC 820 also provides a conceptual framework—and practical guidance—for the measurement of fair value. ASC 820-10-20 defines the fair value standard of value as follows:

This standard of value may—or may not—be sufficiently similar to the standard of value applied in the family law valuation.

THE PURPOSE OF THE VALUATION ANALYSIS

As indicated in the MPF, the purpose of the valuation analysis describes the following:

- The audience for the intangible asset valuation (*i.e.*, the party or parties who will rely on the valuation analysis and the value conclusion)
- The decision (if any) that will be influenced by the analysis results

The purpose of the valuation analysis also indicates the following:

- Why the intangible asset valuation is being performed
- The intended use(s) of the intangible asset valuation
- Who is expected to (and permitted to) rely on the results of the intangible asset valuation

BUNDLES OF LEGAL RIGHTS

In a business combination, the intangible asset ownership interest transferred is not always a fee simple interest. The acquiree may not own the total bundle of legal rights related to the transferred intangible asset, or the acquiree may not have transferred the entire bundle of legal rights to the acquirer. Therefore, the analyst should consider (and document in the assignment understanding) what bundle of legal rights is encompassed in the intangible asset valuation. Some of the alternative intangible asset legal rights that may be transferred (and, therefore, subject to valuation) in a family law matter include the following:

- Fee simple interest
- Life interest or estate
- Term interest or estate
- Licensor/franchisor interest
- Licensee/franchisee interest
- Sublicense interest
- Reversionary interest
- Development rights
- Exploitation rights

- Use rights
- Other contractual rights

DATA GATHERING AND DUE DILIGENCE

Whether related to acquisition accounting or family law purposes, the analyst typically gathers and analyzes information related to the intangible asset owner/operator. Such information may typically include the following:

- The owner/operator historical and prospective financial statements
- The owner/operator historical and prospective intangible asset development/maintenance costs
- The owner/operator current and expected total production resource/capacity constraints

As one part of the analysis, the analyst typically describes and quantifies the intangible asset economic benefits to the owner/operator. Examples of such economic benefits include the following:

- Associated revenue increase (*e.g.*, related product unit price/volume, market size/position)
- Associated expense decrease (*e.g.*, expense related to product returns, COGS, SGA, R&D)
- Associated investment decrease (*e.g.*, inventory, capital expenditures)
- Associated risk decrease (existence of intangible asset licenses/contracts, decrease in the cost of capital components)

The analyst challenges the owner's financial projections.

In the above list of factors, the word "associated" means the economic benefits that can be associated with—or attributed to—the identifiable intangible asset.

In addition, the analyst typically performs an assessment of the intangible asset impact on the owner/operator strategic position. That is, the analyst typically considers the impact of the identifiable intangible asset on the owner/operator's SWOT—strengths, weaknesses, opportunities, and threats.

MARKET PARTICIPANT/MARKET POTENTIAL

In addition to assessing the economic benefit to the owner/operator, the analyst typically considers the intangible asset market potential outside of the owner/operator—that is, to the market participant. In this assessment of the intangible asset economic benefit to the market participant, the analyst may consider the following factors:

- Change in the market definition or the market size for the intangible asset to an alternative (market participant) owner/user
- Change in the alternative/competitive uses of the intangible asset to an alternative (market participant) owner/user
- The subject intangible asset's ability to create inbound or outbound license opportunities to an alternative (market participant) owner/user

In particular, the analyst typically considers whether the owner (or a market participant) can both (1) operate the identifiable intangible asset in the acquired entity and also (2) outbound license the identifiable intangible asset (for use in different products, different markets, different territories, etc.).

The UEL considers technology obsolescence.

ANALYST'S REVIEW OF FINANCIAL PROJECTIONS

As indicated in the MPF, the analyst typically reviews and challenges (1) any owner/operator-prepared financial projections and (2) any owner/operator-prepared measures of intangible asset economic benefits. These due diligence procedures would apply to any financial projections prepared by either (1) the acquiree company management or (2) the acquirer company management.

As part of the prospective financial information due diligence process, the analyst may perform the following benchmark analyses:

- Compare any owner/operator-prepared prior financial projections to the owner/operator's prior actual results of operations
- Compare any owner/operator-prepared projections to the owner/operator's current capacity constraints
- Compare any owner/operator-prepared financial projections to the current total market size (for the market in which the intangible asset owner operates)
- Consider any published industry data related to average comparable profit margin (CPM) for other companies that participant in the intangible asset owner's industry
- Consider any published data related to the CPM of guideline publicly traded companies that participate in the intangible asset owner's industry
- Consider the quality and quantity of available intangible asset license data; these data could relate to the inbound or outbound license of the intangible asset or these data could relate to the arm's-length use licensees of comparable uncontrolled transaction (CUT) intangible assets
- Perform a useful economic life (UEL) analysis, with consideration of the following factors:
    - Any legal/statutory life indication
    - Any contract/license life indication
    - Any technology obsolescence life issues
    - Any economic obsolescence life issues
    - The lives of any prior generations of the subject intangible asset
    - The current position of the subject intangible asset in its life cycle

ASC 805 pays particular attention to the estimation of the intangible asset UEL. This is because the estimated UEL directly or indirectly affects the valuation of the identifiable intangible asset in each of the three generally accepted intangible asset valuation approaches (described below). In addition, for financial accounting purposes, the UEL affects the amortization period for intangible assets with a determinable UEL.