

The challenge of valuing intangible assets

Chances are, if you were asked to list critical corporate assets you would envision traditional tangible assets like land, buildings, inventories and equipment. Traditional tangible assets certainly are important, but pale in comparison to some of the most critical resources possessed by corporations today. Believe it or not, it is not uncommon for intangible assets to be the prized target in many corporate mergers, acquisitions, buyout and gifting situations!



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properties lack physical substance. Agreements are developed because of the significant economic value these important commodities possess.

The skill in which a company can value and, subsequently, deploy its intangible assets has become an important objective for which successful corporations strive. This is, however, easier said than done. Being able to unlock the value of these assets to gain monetary advantage over competitors is the necessary first step. That is why valuation of these precious assets has become an integral part of the corporate quest to meet its financial goals.

Intangible assets represent certain legal rights that have either a useful life or infinite life. These rights afford a company a competitive advantage. But despite their relative importance, intangible possessions are hard to quantify. In fact, classification is particularly difficult because these assets differ significantly in their characteristics, useful lives and types of applications within the operations of a company. Consequently, comprehensive valuation requires an expert and systematic approach.

Characteristics and Types of Intangible Assets

The diverse array of intangible assets has unique characteristics, so each type of asset presents different valuation challenges. Many intangible holdings can be specifically identified, like patents and copyrights. Intangible assets can also be considered relative to their "shelf life," and will have a determinate life span established by law or contract. Others, like franchises, have the characteristic of transferability.

Different types of intangible assets are also classified by the manner in which they are ulti-

mately used. The following is a representative list of some distinct categories:

- Business-associated intangibles: trademarks and trade names, branding/logo (unique color, shape or design) and assembled workforce;
- Consumer-associated intangibles: customer lists and trade secrets;
- Talent-associated intangibles: literary works (books, magazines and newspapers) or musical works (compositions and lyrics);
- Contractual-associated intangibles: licensing, royalty and franchise agreements;
- Technological-associated intangibles: software evolution and research and development.

The Valuation Process

A valuation cannot proceed without a definitive premise of value. However, this value does not remain in the abstract. It is analyzed within the framework of its use of time, place, purpose and importance to the ultimate user. As is the case with beauty, in many instances, the ultimate value of an intangible asset is in the eye of the beholder. Valuation, therefore, depends first and foremost on defining the premise of value. This requires identifying the recipient of the valuation and how it will be utilized.

Asset valuations have different purposes, some circumstances may include:

1. estimate the cost of replacement;
2. assist in setting a selling price;
3. calculate the amount of estate, gift or income taxes;
4. determine the amount of a damage claim;
5. estimate the value of property as collateral in a loan transaction.

Attributes to Consider in the Valuation Process

For a unique intangible asset to exist from either an economic or valuation perspective, it should exemplify certain well-defined attributes. Simply stated, there should be a specific bundle of rights affiliated with the existence of any discrete intangible asset. To possess an economic, quantifiable value, an intangible holding must possess several common attributes. One example is the ability to generate some measurable economic benefit to the business. This is evaluated by comparing the amount of income otherwise generated by the business if that particular asset did not exist.

Valuation Approaches

There are three acceptable valuation approaches that are employed when determining the value of intangible assets. The method ultimately used depends on the asset to be valued and the circumstance or reason for value. The three methods are:

1) The Cost Method: This appraisal technique measures the cost to develop the intangible asset, with the appraiser determining the labor, materials, overhead costs and other expenses involved. When using this approach, the appraiser must determine the total costs

that would be used to recreate a substitute intangible asset with the same functionality as the existing one.

Computer software, product development and an assembled and trained workforce are often valued using this method.

2) The Income Method: This process is directed towards the income-producing capability of the asset. The underlying basis is that the value of the asset should be measured by the present worth of the future net-income stream over the asset's determined life. Examples of assets valued in this way include patents, trademarks and copyrights.

3) The Market Method: This method (also called the sales-comparison approach) is the most direct and easily understood appraisal technique. By measuring the present value of the future benefit of the asset and by obtaining a consensus of what others in the marketplace judge the price to be establishes the actual worth of the asset in accordance with industry-wide standards. In this case, the value derived by this method usually represents the best indicator of the actual value of any asset to be sold. There is, however, one drawback: intangible assets typically have unique characteristics that are not always suited for an equivalent marketplace analysis and the market approach relies on the existence of guideline market data. Consequently, the comparability of one particular asset to another may be speculative and the appraiser must exercise professional judgment when selecting comparables.

The Cost, Income and Market Methods are three ways to value intangible assets. But regardless of the specific valuation approach employed, it is imperative that a comprehensive analysis of the specific market also be considered. It is only after this thorough evaluation, in conjunction with an assessment of the competition and alternative technologies, that an accurate valuation of an asset can proceed.

Summary

When it comes to valuing intangible assets, the tools of the trade are the three methods outlined above. In fact, it's safe to say virtually any type of intangible property can be valued using one of these approaches. But because a significant part of an intangible asset's value is based on the ability to delineate the relevant markets and project the cash flow attributed to the asset, an understanding of these factors is also critical. Consequently, a skillful appraiser's experience and competent interpretation of all relevant information is paramount.

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