The Identification of Commercial Intangible Assets

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Valuation analysts routinely perform several different types of economic analyses with respect to commercial (i.e., business-related) intangible assets. These different types of economic analyses include: valuation, lost profits and/or economic damages analysis, royalty rate (license fee) analysis, intercompany transfer price estimation, and remaining useful life (RUL) measurement. There are generally accepted approaches, methods, and procedures with regard to each type of intangible asset economic analysis. All of these analyses have one common initial procedure: the identification of the intangible asset subject to analysis.

Introduction

The meaning of the term "intangible asset" is widely understood by experienced valuation analysts. However, business owner/operators, securities investors and securities markets regulators, accountants and auditors, government regulators, lawyers and judges, and other interested parties may not be as familiar as valuation analysts with the identification and valuation of commercial (i.e., business enterprise-related) intangible assets. However, all of these interested parties should be aware of the generally accepted definition of intangible asset within the financial valuation profession.

Of course, there are specific statutory, judicial, or administrative definitions for the term intangible asset. These definitions may apply for particular legal, accounting, regulatory, taxation, and other purposes. Therefore, the valuation analyst should always be cognizant of the context and circumstances in which the term intangible asset is discussed.

This discussion provides an overview of the process that valuation analysts commonly follow in the identification and valuation of commercial intangible assets. In addition, this discussion "locates" intangible assets within the entire spectrum of commercial (or business enterprise) assets. Finally, this discussion summarizes the generally accepted approaches, methods, and procedures that valuation analysts use to quantify the value of commercial intangible assets.

The Four Categories of Business Assets

From an applied microeconomics perspective, an asset is anything that (1) can be owned and (2) has value. If an owner/operator can't own the subject economic phenomenon, then it is not an asset. If the subject economic phenomenon exists and can be owned—but it has no value, then it is not an asset.

Therefore, for an intangible asset to meet the first threshold test of existence (i.e., in order for an intangible to be an asset), it should be (1) subject to ownership and (2) have value. These are the tests that the valuation analyst (or any other financial economist) considers when deciding if a particular intangible is, in fact, an asset.

For a variety of accounting, legal, and other reasons, financial economists often group all business or commercial assets into the following four categories:

1. tangible real estate
2. intangible real property
3. tangible personal property
4. intangible personal property

Therefore, for any asset categorization purpose, one way to identify any type of commercial asset (whether tangible or intangible) is to locate that asset in one of the four boxes that are depicted in Figure 1.

Figure 1
The Four Categories of Business Assets

	Realty	Personalty
Tangible	Tangible Real Estate	Tangible Personal Property
Intangible	Intangible Real Property	Intangible Personal Property

Real Estate

Most casual business observers are familiar with the real estate category of assets.

First, real estate is tangible. The fact that real estate is tangible means that the value of real estate comes from its physical elements. The fact that real estate is realty means that it is not moveable. Real estate is either physically part of the earth (e.g., land) or it is physically attached to the earth (e.g., buildings). Therefore, real estate is (practically) immobile, and the value of real estate comes from the owner's ability to occupy, traverse, build on, drill into, or otherwise physically interact with this tangible asset.

Examples of real estate are easy to identify: land, land improvements, buildings and permanently affixed structures, building improvements, and so forth.

Tangible Personal Property

Most casual business observers are also familiar with the tangible personal property category of assets.

First, like real estate, tangible personal property is tangible. Again, that means that the value of tangible personal property comes from its physical elements. The fact that tangible personal property is personalty means that it is moveable. Personal property can be moved from one location (i.e., from one piece of real estate) to another location (i.e., to another piece of real estate). The value of tangible personal property comes from the owner's ability to physically interact with this tangible asset.

Examples of tangible personal property are also easy to identify: industrial machinery and equipment, trucks and transportation equipment, office furniture, computer and laboratory equipment, and so on.

Intangible Real Property

Most casual business observers are at least generally familiar with the intangible real property category of assets.

This is because legal interests in real estate are often subdivided and transferred. Real property assets are the transferable legal interests in tangible real estate. The value of this category of real property asset does not come from the ownership of the tangible real estate asset itself. This is because a separate party (e.g., a landlord, a lessor, or a licensor) owns the real estate.

However, the subject real property asset owner owns the right to use, occupy, cross over, extract from, etc. the subject real estate. The actual real property asset is an intangible asset. The value of intangible real property comes from the legal rights associated with that intangible asset—and not from the ownership of the physical asset itself.

"Examples of real property assets include: leases, occupancy permits, building permits, surface rights, air rights, mining rights, water extraction rights, drilling rights, and so forth."

Examples of real property assets include: leases, occupancy permits, building permits, surface rights, air rights, mining rights, water extraction rights, drilling rights, and so forth.

These intangible assets are often documented in a license, lease, easement, right of way, or other contract. The tangible evidence of the intangible real property right is the document (e.g., the contract). The contract is an asset; it can be owned. The contract has a tangible element: it is a written document. But, the value of the contract does not depend on the physical aspects of the contract paper. Rather, the value of the intangible real property contract depends on the legal rights (and economic expectations) associated with the contract paper.

Intangible Personal Property

More sophisticated business analysts are certainly familiar with intangible personal property.

As mentioned above, real property interests are, in fact, intangible assets. However, some less experienced observers automatically think of the intangible personal property category of assets when they consider the term intangible assets.

That definition of intangible asset (i.e., intangible personal property only) is actually too limited from a financial economics perspective. This is because this definition excludes the intangible real property category of intangible assets. However, it will not necessarily invalidate our explanation of intangible assets to limit our discussion to intangible personal property.

Intangible personal property assets are intangible. The value of these intangible assets does not come from their

physical elements. This does not mean that intangible assets do not have physical elements. In fact, as we will see, all intangible assets should have some physical manifestation of their existence. That manifestation may be a license, contract, financial statement, franchise document, list or listing, drawing, schematic, file, and so on—basically, some type of paper or automated document.

That physical document may be made out of paper; it may be drawn on a blueprint or a Mylar; or, it may be encoded in a computer file. The first important point is that there is some form of tangible evidence of the existence of an intangible asset. The second important point is that the value of the intangible asset does not come from the physical elements of that tangible evidence.

Rather, the value of the intangible asset comes from the legal rights, the intellectual property content, and/or the expected economic benefits that are associated with that intangible asset. Nonetheless, like all assets (tangible and intangible), intangible personal property (1) can be owned and (2) has value.

> ". . . the value of the intangible asset comes from the legal rights, the intellectual property content, and/or the expected economic benefits that are associated with that intangible asset."

The Four Categories of Intangible Assets

Experienced valuation analysts often group all intangible personal property assets into four categories. Sometimes, this intangible personal property categorization process may have accounting, taxation, regulatory, or legal significance. Often, this categorization process just makes sense because the four different categories of intangible personal property assets (although fundamentally similar) have slightly different attributes.

These four common categories of intangible personal property assets are:

1. financial assets
2. general intangible assets
3. intellectual property
4. intangible value in the nature of goodwill

Virtually all business observers are familiar with financial assets.

While some inexperienced valuation analysts don't think of this first category of intangible personal property as an intangible asset, this category may be the best illustrative example of an intangible asset.

Common examples of financial assets include: cash, accounts and notes receivable, stocks and bonds, and other negotiable investment securities. When the subject financial assets owner is a commercial enterprise, these intangible assets are recorded as "current assets" for financial accounting purposes.

Financial Assets

As mentioned above, a financial asset may be the most conceptually clear example of an intangible asset. Let's consider the example of cash—in the form of a $100 bill. If the $100 bill is owned by a commercial business, it is recorded as cash, that is, a current asset, on the commercial entity's financial accounting balance sheet. If the $100 bill is owned by an individual, it is still recorded as cash, that is, a current asset, if the individual prepares a personal financial statement.

There would likely be no question at all that the $100 bill (1) is an asset and (2) has value. However, the value of the $100 bill does not result from the actual paper note. Rather, the value of the $100 bill results from the fact that the intangible asset owner has the legal right to exchange the paper instrument for goods and services. The value of this $100 bill intangible asset comes from the expected economic benefits it can provide to the intangible asset owner.

General Intangible Assets

The second category of general intangible assets includes most other commercial and personal intangible assets. The economic attributes and common subcategorizations of these discrete (or individual) intangible assets will be presented below. Because this is a broad, catch-all category, most intangible personal property assets maybe classified as general intangible assets.

Intellectual Property

There is a distinct subcategory of intangible assets called intellectual property. Intellectual property intangible assets are distinguished by their special legal recognition and, therefore, their specific legal rights.

There are only four types of intellectual property included in this third category of intangible assets:

1. trademarks
2. patents
3. copyrights
4. trade secrets

The special economic attributes of these intellectual property intangible assets will be discussed below.

Goodwill

Experienced valuation analysts typically consider goodwill to be a separate (or fourth) category of intangible assets for various accounting, taxation, and other specific reporting purposes. As indicated above, the intangible asset owner should be able to list and describe all of the other types of intangible assets:

1. financial asset instruments
2. general commercial intangible assets
3. intellectual property

Goodwill is often considered to be a residual intangible asset. That is, for financial economics purposes, goodwill is often considered to be the intangible value component of a commercial entity that cannot be specifically assigned to (or identified with) any of the other above-mentioned three types of intangible assets.

Nonetheless, like the other three categories of intangible assets, goodwill (1) can be owned and (2) can have value. So, while goodwill is an intangible asset, goodwill is not as easy to identify or to analyze as the other types of intangible personal property.

A discussion of some of the procedures that experienced valuation analysts use to identify and quantify goodwill will be discussed below.

Four Categories of Assets

In summary, from an applied microeconomics perspective, there are four categories of business assets. Each of these four categories of business assets may have several subcategories. Two of the primary asset categories represent tangible assets, the value of which comes directly from their physical elements. Two of the primary asset categories represent intangible assets, the value of which does not come from their physical elements.

Two of the primary business asset categories are immobile, so they relate to real estate. Two of the primary business asset categories are moveable, so they relate to personal property.

We considered several subcategories of the intangible personal property asset category. These intangible personal property assets are commonly referred to as "intangible assets." The economics and other attributes of these intangible assets will be discussed below.

The following Figure 2 expands the listing and relationships of the four business asset categories that were introduced in Figure 1:

Figure 2
The Four Categories of Business Assets With Illustrative Examples

	Realty	Personalty
Tangible	land building components building structures	machinery and equipment trucks and autos computers office equipment
Intangible	leaseholds easements and rights of way mining and mineral rights land use permits	financial assets general intangible assets intellectual property goodwill intangible value

The following discussion will summarize how experienced valuation analysts identify, analyze, and value the intangible personal property category of assets. In particular, the discussion will focus on how investors, entrepreneurs, executive managers, financiers, and other capital market participants understand and analyze the economics of (and, particularly, the value of) intangible assets.

Reasons to Analyze Intangible Assets

There are numerous reasons why valuation analysts (and other financial economists) are asked to analyze the economics of intangible assets. Generally, all of these individual reasons may be aggregated into the following eight categories:

1. transaction pricing and structuring
2. intercompany use and ownership transfers
3. financial accounting and reporting
4. taxation planning and compliance
5. financing collateralization and securitization
6. bankruptcy and reorganization
7. litigation claims and dispute resolution
8. management information and strategic planning

For each of these different categories of purposes, the valuation analyst may consider one or more of several related (but subtly different) quantitative objectives:

1. to estimate a defined value associated with the ownership of the subject intangible asset
2. to measure the appropriate royalty rate or intercompany transfer price associated with the use of the subject intangible asset
3. to quantify the expected remaining useful life (RUL) of the ownership or operation (or associated rate of change in the value of) the subject intangible asset

4. to determine the amount of lost profits or other economic damages associated with the subject intangible asset

The focus of this discussion relates to the first category of economic analyses—that is, to estimate a defined value for the subject intangible asset. Nonetheless, there are numerous similarities in the generally accepted approaches, methods, and procedures that experienced valuation analysts use in the performance of all four categories of intangible asset economic analyses.

The following discussion summarizes several of the specific reasons why valuation analysts are asked to analyze an intangible asset. These specific reasons are summarized within the eight categories of reasons presented above for organizational purposes only.

It is noteworthy that the results of these intangible asset valuation analyses are relied on by numerous parties to make investment, financing, taxation, contractual, and other decisions. The types of parties who routinely rely on intangible asset valuation analyses include:

1. intangible asset developers, owners, and operators
2. merger and acquisition intangible asset licensors and licensees
3. merger and acquisition intangible asset buyers and sellers
4. financial institutions and financial intermediaries
5. governmental and regulatory authorities
6. taxation agencies and authorities
7. accountants and auditors
8. judges and lawyers
9. professional capital market participants
10. individual security investors

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The above-mentioned list of parties routinely rely on intangible asset valuation analyses that are prepared for the reasons listed in Exhibit 1. The Exhibit 1 listing of 26 common reasons to value intangible assets is based on the eight categories of intangible asset valuation reasons presented above.

Intangible Asset Economic Attributes

This discussion introduces the economic attributes that experienced valuation analysts consider in the process of identifying the existence of intangible assets. Of course, before an intangible asset can be valued, it has to be (1) identified and (2) analyzed.

This discussion will describe some of the economic attribute features that help the valuation analyst to determine that an intangible asset in fact exists.

The following discussion will then summarize the generally accepted approaches and methods that valuation analysts use to (1) analyze and (2) value the identified intangible assets.

According to the textbook *Valuing Intangible Assets*,[1] some of the more common characteristics or attributes necessary for identification as an intangible asset include the following:

1. The intangible asset should be subject to specific identification and recognizable description.
2. The intangible asset should be subject to legal existence and protection.
3. The intangible asset should be subject to the right of private ownership, and that private ownership should be legally transferable.
4. There should be some tangible evidence or manifestation of the existence of the intangible asset (e.g., a contract, a license, a registration document, a listing of customers, a set of financial statements, etc.).
5. The intangible asset should have been created or have come into existence at an identifiable time or as the result of an identifiable event.
6. The intangible asset should be subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event.

In other words, there should be a specific bundle of property rights associated with the existence of any intangible asset.

There is a distinction, that is often substantial, between the existence of an intangible asset and the value of the intangible asset. The above six-item list describes the economic attributes of an intangible asset. Valuation analysts consider these economic attributes in order to determine the existence of an intangible asset.

For an intangible asset to have a determinable value, it should also possess the following two economic attributes:

1. The intangible asset should generate some measurable amount of economic benefit to its owner. This economic benefit could be in the form of an income increment, a cost decrement, and/or an investment decrement.
2. The intangible asset should be able to enhance the value of the other assets (tangible or intangible) with which it is associated.

Exhibit 1
26 Common Reasons to Value Intangible Assets

A. Transaction pricing or structuring reasons
1. Pricing the sale of an individual intangible asset or a bundle of two or more intangible assets.
2. Pricing the license of an individual intangible asset or a bundle of two or more intangible assets.
3. Equity allocations in a de novo business enterprise or joint venture when different investors contribute different tangible assets and intangible assets.
4. Asset allocations in the liquidation of a seasoned business enterprise or joint venture when different investors receive tangible assets or intangible assets in exchange for their equity ownership.

B. Intercompany use and ownership transfers
5. Transfers of intangible assets between wholly owned subsidiaries (or other business units) of a consolidated business enterprise.
6. Transfers of intangible assets between less than wholly owned subsidiaries (with different minority shareholders) of a consolidated business enterprise.
7. Cost accounting allocations and inventory pricing when in-process goods are transferred between entities with varying intangible asset ownerships in a consolidated business enterprise.

C. Financial accounting and reporting
8. Business acquisition purchase price allocations among all acquired assets.
9. Goodwill and other intangible asset impairment testing.
10. Post-bankruptcy "fresh start accounting" for all tangible and intangible assets.

D. Taxation planning and compliance
11. Business acquisition purchase price allocations among all acquired assets.
12. Depreciation and amortization accounting for purchased tangible and intangible assets.
13. Charitable contribution deductions related to donated intangible assets.
14. Intercompany transfer pricing of intangible assets owned by cross border subsidiaries of a multinational corporation.
15. State and local ad valorem property tax appeals related to exempt intangible assets.

E. Financing collateralization and securitization
16. Use of cash-flow-based intangible assets as collateral on corporate debt/financings.
17. Sale/leaseback or sale/licenseback financing of corporate intangible assets.

F. Bankruptcy and reorganization
18. Use of intangible assets as secured creditor debt collateral.
19. Use of intangible assets as debtor-in-possession (DIP) secured debt collateral.
20. Sale or license of intangible assets as spinoff opportunity.
21. Use of corporate intangible assets in assessment of solvency or insolvency.

G. Litigation claims and dispute resolution
22. Intellectual property royalty rate analysis in infringement claims.
23. Breach of contract or noncompete agreement damages claims.
24. Condemnation, expropriation, eminent domain, dissipation of corporate assets claims.

H. Management information and strategic planning
25. Formation of intellectual property joint venture, joint development, joint commercialization agreements.
26. Negotiation of inbound or outbound intellectual property (or other intangible asset) use, development, commercialization, or exploitation agreements.

Let's consider an example of the difference between an intangible asset with existence and an intangible asset with value. Let's consider a legally registered patent that the owner has decided to file in the corporate vault and not commercialize. In this unlikely example, the patent owner has decided not to generate, license, or in any other way use the subject intellectual property.

In this example, we assume that the subject patent has legal standing, and therefore the intangible asset exists. However, the lack of any measurable economic benefit to the patent owner/operator means that the subject intangible asset does not have a measurable value.

Naturally, the extent that intangible assets exist in a commercial business enterprise varies by business enterprise and by industry.

For example, Google Inc. (a company that earns revenue by selling online internet-based advertising), has significant intangible asset value. This intangible asset value is illustrated by the fact that the Google Inc. market value of equity far exceeds the Google Inc. market value of net tangible assets (i.e., tangible assets minus liabilities).

That is, participants in the public equity markets perceive that the Google Inc. business enterprise enjoys an intangible asset value in excess of the tangible assets listed on the company's balance sheet. This additional stock market value may be attributed to Google Inc. intangible assets, such as the company's trained and assembled workforce, patents, copyrights, trademarks and trade names, advertiser relationships, and so on.

". . . valuation analysts and other financial economists often group individual intangible assets into several common categories."

An industrial machine tool shop is an example of a commercial business enterprise at the other end of the intangible asset value-to-total equity value spectrum. Modern machine tool shops generally:

1. require significant investments in capital equipment and machinery,
2.. earn low profit margins (e.g., return on total assets),
3. do not have strong trademark and trade name recognition,
4. do not have long-term contractual relationships with their customers, and
5. do not own the designs for the machine tools that they manufacture (i.e., ownership of the tool designs remains with the machine shop customers).

Although intangible assets do not have as much value in an industrial machine tool shop as in a high technology research company, some intangible assets do exist in the case of a machine shop.

For example, let's consider a machine tool shop that developed a series of operating procedures that have improved the company's operating efficiency over time. Although these process improvements are not a tangible asset, they do provide a positive economic contribution to the value of the business. That is, the subject process improvements represent an intangible asset of the subject machine tool business enterprise (either in the form of a trade secret or a trained and assembled workforce).

Categories of Commercial Intangible Assets

Generally, valuation analysts and other financial economists often group individual intangible assets into several common categories. This categorization of intangible assets is useful for general intangible asset identification and classification purposes.

Intangible assets in each category are generally similar in nature and in function. Also, intangible assets are grouped in the same category when similar valuation methods apply to that category of intangible assets.

It should be noted that the following categorization is presented for discussion purposes only. This valuation analyst categorization does not represent any particular financial accounting, taxation, regulatory, legal, or other authority.

A common valuation analyst categorization of general intangible assets follows:

1. technology-related (e.g., proprietary technology)
2. customer-related (e.g., customer lists, customer engineering drawings and technical documentation relationships, customer contracts)
3. contract-related (e.g., favorable supplier contracts, technology sharing agreements, franchise agreements)
4. data-processing-related (e.g., computer software, automated data bases)
5. human-capital-related (e.g., a trained and assembled workforce, noncompete covenants, employment agreements)
6. marketing-related (e.g., advertising materials, marketing brochures and materials)
7. location-related (e.g., leasehold interests, mineral or mining exploration rights)
8. license-related (e.g., operational or environmental licenses or permits, pollution control permits)

Intellectual Properties

There is a specialized classification of intangible assets called intellectual properties. Intellectual properties manifest all of the identification and valuation economics attributes of other commercial intangible assets. However, because of their special status, intellectual properties enjoy special legal recognition and monopolistic protection.

Other commercial intangible assets are typically created in the normal course of the subject business operations. In contrast, intellectual properties are created by specific human intellectual capital activity. And, such creative activity can be attributed to the activity of specific identified individuals.

In the United States, intellectual properties are typically registered under, and are protected by, specific federal and state statues. These statutes give the intellectual property owner specific legal rights with regard to the commercial development and economic exploitation of the subject intellectual patent. These statutes also give the intellectual property owner the right to prevent other parties from commercializing the subject intellectual property.

Like other commercial intangible assets, intellectual property assets are generally grouped into like categories. The intellectual properties in each category are generally similar in nature, feature, method of creation, and legal protection. Likewise, similar valuation methods and economic analysis procedures may apply to the intellectual property in each category.

". . . because of their special status, intellectual properties enjoy special legal recognition and monopolistic protection."

This common categorization of intellectual property follows:

1. trademark and trade names (including service marks, service names, and trade dress)
2. patents (including utility, design, and plant patents and the associated patent applications)
3. copyrights (including musical and literary compositions, other works of art, and copyrights in computer software and engineering drawings)
4. trade secrets (including processes, designs, diagrams, drawings, schematics, memoranda, etc.)

Intangible Value in the Nature of Goodwill

As mentioned above, goodwill is one category of intangible assets. Unlike other categories of intangible assets which can be individually identified and discretely quantified, intangible value of goodwill is often not as easy to define.

However, intangible value in the nature of goodwill can have a significant impact on the value of an industrial or commercial business enterprise. For that matter, goodwill can have a significant impact on the value on an individual economic (e.g., business enterprise) entity. For example, goodwill may comprise a significant portion of the selling price of a professional practitioner (e.g., physician or lawyer) or a celebrity (e.g., entertainer or athlete).

Accordingly, this discussion will introduce the various definitions of goodwill within the context of an economic analysis of intangible assets. This discussion will emphasize the accounting, taxation, and transactional aspects of goodwill that relate to a substantial commercial business enterprise. In other words, this discussion will not focus on the economic aspects of goodwill that relate to professional practitioners, service providers, celebrities, and so on.

Several of the generally accepted approaches, methods, and procedures related to the valuation of the goodwill of an industrial or commercial business entities will be introduced in the next section of this discussion.

There are important differences between how various professionals interpret and measure intangible value in the nature of goodwill. Valuation analysts and other financial economists typically consider goodwill from a marketplace or transactional perspective. That is, valuation analysts typically consider goodwill the same way that participants in merger and acquisition transactions and other capital market transactions do.

This is because these transactional, financing, and investment decisions are often influenced by the existence of, and the amount of, the goodwill (and other intangible assets) associated with the subject industrial or commercial business enterprise.

That is, valuation analysts typically advise clients with respect to the economics of goodwill (and other intangible assets) that actually affect the pricing and structuring of commercial business transactions.

Financial accountants, tax accountants, and government regulators often have a different perspective regarding the identification and measurement of goodwill. This is because their analyses (including their valuation analyses) have a different objective. These professionals are often more concerned with recording the structure of a transaction that has been consummated. These professionals are less concerned with influencing a transaction that is in the process of negotiation.

For that reason, financial accounting intangible asset valuations are typically rule-based. These rule-based valuations are intended to promote full disclosure to third parties who rely on business enterprise financial statement.

And, these rule-based valuations are intended to be prepared (and interpreted) consistently across financial statements related to all commercial entities. Accordingly,

financial accounting intangible asset valuations have to be rule-based or formula-based.

The objectives of such intangible asset valuations are to be transparent, consistent, replicable, and auditable. That is because, such financial accounting valuations are intended to provide ex post facto information to financial statement readers who were not principal participants in the reported intangible asset transactions.

In contrast, experienced valuation analysts more typically prepare valuations that are intended to provide ex ante information to parties who are principal participants in a pending intangible asset transaction. Such intangible asset valuations are intended to allow clients and other parties to understand the microeconomic effects of a pending transaction, financing, investment, or similar capital market event.

Financial economist intangible asset valuations are more intended to explain the implications of current financial or investment decisions. Such intangible asset valuations are less intended to uniformly report the results of historical financial transactions.

Therefore, most financial economist intangible asset valuations are more based on the application of generally accepted economics principles—and less based on the application of generally accepted disclosure rules.

The parties who rely on financial economist intangible asset valuation analyses are typically sophisticated transactional participants. These parties have access to the relevant transactional data, to the other transactional participants, and (typically) to the valuation analyst.

> *"Financial economist intangible asset valuations are typically performed for transaction purposes."*

Financial accounting intangible asset valuations are typically performed for public accounting and reporting, tax accounting compliance, regulatory disclosure, and other important administrative purposes. Therefore, such intangible asset valuations are more rules-based.

Financial economist intangible asset valuations are typically performed for transaction purposes. These valuation analyses are implicitly or explicitly considered in fairness opinions, solvency (or insolvency) opinions, private inurement opinions, adequate consideration opinions, fair market valuations, and other commercial transaction financial advisory opinions. Therefore, such intangible asset valuations are more economics-based.

Financial Accounting Analysis of Intangible Value in the Nature of Goodwill

Under U.S. generally accepted accounting principles (GAAP), the goodwill value that a business enterprise develops is rarely recorded on the financial statements of that business entity. That is, internally developed goodwill is not recorded as an intangible asset under U.S. GAAP.

In contrast, purchased goodwill acquired in a business combination is recorded by the corporate acquirer when a business enterprise is acquired. According to the textbook *Intangible Assets*, "Goodwill, as defined by financial accountants, is a residual, created when one firm buys another firm for more than the fair value of the net identifiable assets, both tangible and intangible."[2]

There are a few other isolated instances when a business entity's goodwill is recorded on the company's financial statements under U.S. GAAP. One such example would be the pushdown accounting rules related to a corporate reorganization. But the instances in which a company's developed goodwill (as opposed to its purchased goodwill) is recorded for accounting purposes are extremely rare.

As illustrated above, financial accountants use a residual definition of goodwill. To the financial accountant, intangible value in the nature of goodwill typically represents the total value of the subject business enterprise (often represented by the actual purchase price paid for the subject business in a merger or acquisition transaction) less the total value of the subject business real property and tangible personal property.

That is, the value of goodwill is the total value (i.e., the acquisition purchase price) of the subject business less the value of the subject business tangible assets.

So, by the financial accountant's residual definition, intangible value in the nature of goodwill generally includes all of the intangible value of a business enterprise. This is often the case even if much of the intangible value comes from identifiable intangible assets.

Financial Economics Analysis of Intangible Value in the Nature of Goodwill

The financial economist's definition of goodwill value is somewhat more specific than the financial accountant's definition of goodwill. Also, the financial economist's definition of goodwill value is more useful to valuation analysts who are interested in the identification and valuation of the specific goodwill intangible asset.

Financial economists define the goodwill intangible asset as the capitalization of all of the business enterprise economic income that cannot be associated with any other tangible or intangible asset of the subject business enterprise. For purposes of this goodwill definition, economic income may be defined several different ways. It can mean net cash flow, before or after debt service; net income, before or after income taxes; net operating income; and so forth.

An important consideration is that in the economic income capitalization process, the capitalization rate (whether a yield capitalization rate or a direct capitalization) used should be consistent with the definition of economic income used.

So, in the valuation of business enterprise goodwill, first the financial economist will quantify all of the economic income of the subject business enterprise.

Second, the financial economist will allocate or assign some portion of the total economic income to each of the subject business tangible assets and identified intangible assets that contribute to the production of that income. These tangible and intangible business enterprise assets typically include: the net working capital, the tangible personal property, the real estate, and the identified general intangible assets, and the intellectual property (i.e., patents, copyrights, trademarks, and trade secrets).

Third, that portion of the business total economic income that cannot be reasonably allocated to any other tangible and intangible asset—that is, the residual economic income—is quantified and assigned to the goodwill intangible asset.

And, fourth, the capitalization of this residual economic income represents intangible value in the nature of goodwill.

> "There are three principal components of business enterprise goodwill value."

Components of Goodwill Value

There are three principal components of business enterprise goodwill value. These components may be considered the factors that cause goodwill or the reasons why goodwill exists in certain circumstances.

The first component of goodwill is an assemblage factor. It is the incremental intangible value associated with the fact that the subject business enterprise assets are in place and ready to use. This component is sometimes referred to as the going-concern value element of goodwill.

According to *The Appraisal of Real Estate*, this value "includes the incremental value associated with the business concern, which is distinct from the value of the real property. The value of the going-concern includes an intangible enhancement of the value of the operating business enterprise, which is produced by the assemblage of the land, building, labor, equipment, and the marketing operations. This assemblage creates an economically viable business that is expected to continue. The value of the going-concern refers to the total value of the property, including both real property and the intangible personal property attributed to business enterprise value."[3]

The fact that all elements of a business enterprise are physically and functionally assembled creates value. These elements of a business enterprise include: (1) capital (e.g., equipment), (2) labor (e.g., employees), and (3) coordination (e.g., management). Some of the value created by the assemblage factor component of goodwill enhances the value of each of these three elements of the business enterprise.

For example, the value of the equipment is typically greater when it is appraised on an assembled, going-concern basis (as compared to on a piecemeal, liquidation basis).

Likewise, the existence of a trained and assembled workforce enhances the value of a business. The trained and assembled workforce is an identifiable intangible asset. In much the same way that assembled equipment or an assembled workforce adds value to the business enterprise, the combined assemblage of all of the subject tangible assets and intangible assets will add value to the business enterprise. Some of this assemblage value will inure to the goodwill intangible asset.

The second component of goodwill is the existence of excess economic income. This component of goodwill was discussed briefly above. Excess income is that amount of income generated by a business enterprise that is greater than the amount that would be considered a fair rate of return on all of the other tangible assets and intangible assets that are used in the subject business.

The excess economic income component relates directly to the definition of goodwill value as the value of a business enterprise that cannot be assigned to any of the other tangible assets or identified intangible assets of the subject business.

The third component of goodwill is the expectation of future events that are not directly related to the current operation of the subject business enterprise. For example, goodwill value may be created by investors' expectations of (1) future capital expenditures, (2) future mergers and acquisitions, (3) future products or services, and (4) future customers or clients.

This expectational component of goodwill relates directly to the definition of goodwill as the current value of future assets not yet in existence as of the valuation date.

Investors (and owners) assign a goodwill value to a business enterprise if they expect the net present value of the income associated with the future events to be positive. In the financial economic literature, this goodwill component is sometimes called the present value of growth opportunities (or PVGO).

Of course, the net present values of the assets currently in existence (e.g., capital assets, product lines, customers, etc.) are assigned to those respective tangible assets and intangible assets.

Intangible Asset Valuation in a Location-Dependent Business Enterprise

Overview

The identification and valuation of intangible assets may be particularly important in transactions involving the transfer of a location-dependent or special purpose business enterprise. This is because, in a location-dependent special purpose business enterprise, the entity's intangible assets typically sell with, and their values may be misallocated to, the subject business real estate.

Special purpose businesses (sometimes referred to as special purpose properties) are properties built with unique characteristics useful only for a specific purpose or designed for a specific location. According to the Institute for Professionals in Taxation:

> A special purpose property is uniquely designed and adapted to the business conducted upon it or the use made of it. It cannot be converted to another use without the expenditure of substantial sums of money.[4]

One of the characteristics of many special purpose properties is that they are location dependent. These location-dependent, special purpose businesses typically operate under the regulatory governance of a license, permit, franchise, certificate, and so on. These intangible legal rights—collectively, the right to engage in the specified commercial business—are often site-specific. And, except by regulatory approval, these intangible assets are not readily transferable between locations.

In these instances, the subject business enterprise cannot easily continue without the specific real estate. And, the subject real estate may suffer a substantial diminution in value without the subject business enterprise (and subject business-related intangible assets).

Many regulated retail businesses have such intangible assets. For example, restaurants and bars typically need liquor licenses. A retail liquor store needs a license to sell alcohol. A race track or a casino needs a gaming license. The subject businesses simply can not operate without these intangible asset licenses.

Many regulated service businesses also have such intangible assets. For example, hospitals and nursing homes require certificates of need (and perhaps other licenses, as well). These health care institutions may only operate within the parameters specified by the granted certificates. And, the certificates may not be transferred without specific regulatory approval.

Clearly, the value of such a business enterprise would be greatly diminished without the location-specific intangible assets. For example, the value of a bar or liquor store business is nominal without a liquor license (or the imminent prospects of obtaining such a liquor license).

And, the value of the owned or leased real estate (in particular, special purpose real estate) is greatly diminished without the subject location-specific intangible asset. For example, the value of a race track or a casino is greatly reduced if the owner loses (or cannot obtain) a gaming license intangible asset.

Generally, when there are site-specific regulatory permits or licenses required to operate a business, the value of these location-related intangible assets should be separately considered in the valuation of the subject real estate.

In some instances, special purpose businesses can not relocate due to physical conditions. These businesses are completely dependent upon the location and/or resources of the subject real estate. Accordingly, it is often not possible (and practically not necessary) for valuation analysts to disaggregate the value of the intangible real property associated with the real estate value in this category of business enterprise.

Examples of such intangible real property include air rights, water rights, mineral rights, mining and mineral rights, and so on. Obvious examples of business entities in this category include agriculture farms (that depend upon the soil), quarries and mining operations (that depend upon the natural resources), beach front hotels (that depend upon water frontage), and so on.

In the valuation of a business that is completely dependent upon the resources of the subject real estate, it is common for the valuation analyst to value the subject intangible personal property (and not the subject intangible real property) separately from the subject real estate.

Reasons to Quantify Intangible Asset Values Related to a Location-Dependent Business

In addition to the above described reasons to disaggregate intangible asset value from real estate value in location-dependent special purpose businesses, there are a number of other individual legal, accounting, and taxation reasons to perform this valuation allocation procedure.

Several of these specific reasons to quantify intangible asset values in a location-dependent business are described below:

1. state and ad valorem property tax reporting
2. real estate transfer sales tax reporting
3. purchase price allocation financial accounting
4. purchase price allocation tax accounting
5. real estate loan collateral value determination
6. bankruptcy and reorganization accounting
7. negotiating the sale price of a property

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8. recording the shareholder's contribution of real estate to a business enterprise
9. recording the distribution of real estate from the business enterprise to shareholders
10. recording a like-kind exchange of real estate for federal income tax purposes

Summary and Conclusion

This discussion summarized the four general categories of commercial business assets. This discussion also summarized the four common categories of commercial intangible assets. In particular, this discussion focused on the economics attributes that valuation analysts consider in the identification of commercial intangible assets.

This discussion described many of the common reasons why valuation analysts (and other financial economists) are asked to value commercial intangible assets. In particular, this discussion focused on the different contexts for the identification and valuation of intangible value in the nature of goodwill.

Finally, this discussion explained a generally accepted method for the identification and valuation of intangible assets within the context of a location-dependent or special purpose business enterprise.

Corporate acquirers, securities investors, financial accountants, licensors and licensees, government regulators, taxing authorities, and judges and lawyers often have an interest in the economic analysis of business intangible assets. These parties should be aware that there are generally accepted approaches, methods, and procedures related to the identification and valuation of commercial intangible assets.

Notes:

1. Robert F. Reilly and Robert P. Schweihs, *Valuing Intangible Assets* (New York: John Wiley & Sons, 1999).
2. Jeffrey A. Cohen, *Intangible Assets* (New York: John Wiley & Sons, 2005), p. 23.
3. *The Appraisal of Real Estate*, 12th ed. (Chicago: Appraisal Institute, 2001), p. 27.
4. Jerrold F. Janata, ed. *Property Taxation*, 2nd ed. (Washington D.C.: Institute for Professionals in Taxation, 1993), p. 379.

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