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VALUE ADDED™

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Valuing Intangible Assets
A Primer

Whether an asset is tangible or intangible, it should be subject to the rights of property. For an intangible asset to qualify as property it should enjoy all the legal rights, benefits, and privileges of property. It should be subject to identification, legal existence and protection, right of private ownership that is legally transferable, have evidence of its existence, have been created at an identifiable time, and be subject to being destroyed. In order to have economic value the intangible asset should generate some measurable amount of economic benefit to its owner and enhance the value of the other assets with which it is associated.

"The primary complicating factor for intangible asset valuation is relating specific benefits and ... separating and valuing the intangible asset apart from the larger entity"

Intellectual properties are intangible assets that enjoy special legal recognition and legal protection. Generally categorized as (1) creative (trademarks, copyrights, computer software) or as (2) innovative (patents, industrial designs, trade secrets). Most intellectual properties have a specified legal life and external commercialization opportunities. More transactional data are available for intellectual properties and they enjoy higher royalty rates than other intangible assets.

We could define intangible assets as all the elements of a business enterprise that exist in addition to monetary (working capital) and tangible assets (fixed assets). Their existence is dependent on the presence, or expectation, of earnings. They typically appear last in the development of a business and disappear first in its demise. Intangible assets may be categorized as follows:

1. Rights - such as contracts to receive goods and services at an advantageous price, franchises, contracts to sell goods and services profitably.
2. Relationships - such as assembled workforce, customer relationships, distributor relationships
3. Grouped Intangibles - such as going concern value, goodwill.
4. Intellectual Property - patents, trademarks, copyrights, and trade secrets or know-how.

(Continued on Page 2, Column 1)

Is It Reasonable?
Asset Holding Entity Information

Asset-holding entities are typically partnerships or limited liability companies with assets that include some combination of real estate, marketable securities, and/or closely held securities. As part of the appraisal due diligence process, information is obtained from general partners and/or managing members as well as from a variety of other sources (generally attorneys, real estate appraisers, accountants, securities brokers, and industry contacts). Such information provides a basis for the appraiser to understand the composition, operations, strategy, and governance of the entity. This article focuses on the importance of analyzing, from a valuation perspective, the reasonableness of this information.

When information fails to reconcile with industry or circumstantial norms,

(Continued on Page 3, Column 2)

IN THIS ISSUE

Accounting Treatment of Intangible Assets. Paragraphs 9 through 17 of SFAS 142 prescribe the appropriate accounting treatment for intangible assets other than goodwill. Intangible assets are broadly defined as non-financial assets that lack physical substance. An understanding of the accounting for intangible assets, and the related implications for companies' reported earnings, is facilitated by reference to four categories of intangible assets.

As Figure 1 illustrates, intangible assets developed within the reporting company are not recognized on the company's balance sheet, whereas intangible assets acquired from other businesses (or via a business combination) are considered to meet the definition of an asset. Paragraph 39 of SFAS 141 requires that acquired intangible assets be recognized separately from goodwill if the intangible asset "arises from contractual or other legal rights." As the graphic below illustrates, whether the intangible asset in question is separable from the acquired entity must also be assessed in determining whether the asset should be recognized separately from goodwill. Separability, which is demonstrated by the ability to sell, transfer, license, rent, or exchange the asset, triggers separate recognition regardless of whether the contractual or other legal rights test is met.

In Appendix A to SFAS 141, the FASB provides examples of assets that meet the criteria for recognition separately from goodwill. The specific assets listed are assigned to five distinct categories:

Separable from Acquired Entity	Contractual or Other Legal Right? Yes	Contractual or Other Legal Right? No
Yes	Recognized Separately From Goodwill	Recognized Separately From Goodwill
No	Recognized Separately From Goodwill	Recognized as Goodwill

Figure 2

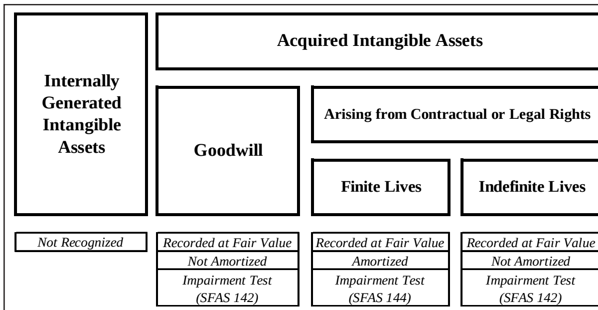

Figure 1

- *Marketing-related intangible assets* such as trademarks and internet domain names
- *Customer-related intangible assets* such as customer lists and order backlogs
- *Artistic-related intangible assets* such as literary and musical works
- *Contract-based intangible assets* such as licensing, lease, and franchise agreements
- *Technology-based intangible assets* such as technology (both patented and unpatented) and computer software

The motivation of acquirers to pay a premium to the fair value of net tangible assets is frequently traced to the control of one or more of these intangible assets. The specific recognition of these assets on the company's balance sheet will require the determination of the fair value of these assets.

The unique nature of intangible assets frequently requires reliance on different benchmarks and data sources than those used in traditional business valuation. Consultation with qualified business valuation professionals experienced in the valuation of intangible assets will likely be considered necessary by reporting companies and their independent auditors.

Finally, intangible assets recognized separately from goodwill must be classified as having either finite or indefinite useful lives. Those intangible assets deemed to have finite useful lives will be amortized over their estimated useful lives (and tested for impairment annually using the undiscounted cash flow test of SFAS 144), while intangible assets having indefinite lives will not be amortized until their useful lives are determined to become finite, at which time they will be amortized. Indefinite-lived intangible assets are to be tested for impairment by comparing their estimated fair values with their carrying values on the balance sheet.

Intangible Asset Valuation. The value of an intangible asset is a function of a stream of future benefits, discounted to the present. The difficulty arises in attaching specific benefits to specific intangible assets. A detailed discussion of intangible asset valuation is beyond the scope of this article. However, the following discussion presents an overview of the three basic valuation approaches (cost, income, and market) applied to intangible assets.

Cost Approach. The cost approach seeks to measure the future benefits of ownership by quantifying the amount of money that would be required to replace the future service capability of the subject intellectual property. The assumption underlying the cost approach is that the cost to purchase or develop new property is commensurate with the economic value of the service that the property can provide during its life. The cost approach does not directly consider the amount of economic benefits that can be achieved nor the time period over which they might continue. It is an inherent assumption with this approach that economic benefits indeed exist and are of sufficient amount and duration to justify the developmental expenditures.

Income Approach. The income approach focuses on a consideration of the income producing capability of the subject intangible asset. The underlying theory is that the value of the subject property can be measured by the present worth of the net economic benefits to be received over the life of the intangible asset.

Market Approach. The market approach provides an indication of value by comparing the price at which similar property has been exchanged between willing buyers and sellers. When the market approach is used, an indication of the value of a specific intangible asset can be gained from looking at the prices paid for comparable property. Requirements for the successful use of this approach include the existence of an active market involving comparable intangible assets, and, access to price information at which comparable intangible assets were exchanged.

Conclusion. Intangible asset valuation theoretically parallels securities valuation; i.e., value is based upon a stream of future benefits discounted to the present. The primary complicating factor for intangible asset valuation is relating specific benefits and costs to specific intangible assets or, stated differently, separating and valuing the intangible asset apart from the larger entity.

Because of the inherently unique nature of many intangible assets, finding transactions involving comparable assets can be difficult. Also, valuing a specific entity or reporting unit could be thought of as the valuation of a portfolio encompassing numerous assets representing different life cycle stages, varying degrees of market potential, and dissimilar current and expected future contribution to entity value. However, the valuation of a single intangible asset necessarily requires a more exact specification of life cycle stage, market potential, future contribution, etc. The considerations can be quite difficult, particularly for assets with relatively undeveloped markets.

Despite these practical valuation challenges, analysts still use the three broad valuation approaches: cost, income, and market. ◆

Is It Reasonable?

(Continued from Page 1, Column 2)

or appears unreasonable or lacking in common sense, appraisers may need to make "normalizing" adjustments. These adjustments attempt to modify reported facts and circumstances to conform to the standard of fair market value. Under the standard of fair market value, the financial characteristics of the valuation subject must make sense and be reasonably representative of the considerations of hypothetical investors.

A hypothetical asset-holding entity can illustrate the concepts. At issue in the example are the reasonableness of the general partner's compensation and the reasonableness of rental income paid to a limited partnership.

Overview of the Hypothetical Asset-Holding Entity. The hypothetical asset-holding entity is a limited partnership with assets consisting primarily of a fractional interest in a commercial building. The property houses a chain retailer in potentially serious financial difficulty as of the valuation date. The property was appraised and the appraisal took into account the partnership's fractional interest by applying a 25% fractional interest discount.

General Partner's Compensation. Approximately 60% of the partnership's current total income (mostly rent) is being paid as compensation to the general partner. In addition to overseeing the management of the partnership, the general partner essentially acted as a property manager. According to our research, industry rates for property management fees generally range from approximately 6% to 11% of collected rents, which is much lower than the 60% the hypothetical general partner is receiving in this scenario. Is this level of compensation reasonable? The answer requires further clarification regarding the amount of the partnership's rental income.

Rental Income. An analysis of the partnership's reported asset values and revenue implies a 20% capitalization rate on annual rental income. Typically, capitalization rates on properties of this nature range from 11% to 15%. Either the rental income is unusually high or the appraisal is potentially flawed by understating the value of the property.

Adjustments. Ultimately, the income and expense profile related to this property affects our analysis of a limited partner's expected liquidity resulting from distributions. This, in turn,

(Continued on Page 4, Column 1)

	Reported	Comments
Pro Rata Market Value of Subject Property	$1,000,000	<> Per Real Estate Appraiser
Less: Fractional Interest Discount of	25.0%	<> Per Real Estate Appraiser
= Fractional Interest in Subject Property	$750,000	
Rental Income	$200,000	<> 20% of Pro Rata Market Value
General Partner Compensation	$120,000	<> 60% of Pro Rata Market Value
Percent GP Compensation to Pro Rate Value	**12.0%**	<> Before Fractional Interest Discount
	Adjusted	
Pro Rata Market Value of Subject Property	$1,000,000	
Less: Fractional Interest Discount	25.0%	
Fractional Interest in Subject Property	$750,000	
Adjusted Rental Income	$110,000	<> 11% of Pro Rata Market Value
Adjusted General Partner Compensation	$11,000	<> 10% of Normalized Rental Income
Percent GP Compensation to Pro Rata Value	**1.1%**	

affects the magnitude of the marketability discount. As appraisers, we have to reconcile the facts from the perspective of a reasonable investor's long-term expectation. The questions we must address are: (1) what is a reasonable and sustainable level of future rental income? and (2) what is a reasonable level of compensation for the general partner?

After conversations with several real estate appraisers, a capitalization rate of 11% was applied to the appraised market value of the subject property (pro rata, exclusive of the fractional interest discount). This provides us with a reasonable and sustainable level of rental income on the property. Correspondingly, we believe that a rational investor would anticipate a lower level of general partner compensation. Such compensation should likely be based on traditional property management rates.

Using the normalized rental income described above, we believe that the general partner should be compensated at approximately 10% of collected rents. Such compensation also reflects the general partner's administration of the entity's overall business.

In Table 1, note that the adjustments applied in this case result in a difference of nearly 11% of asset value. The resulting cash flow would make a potentially significant difference in the growth of the partnership's assets or to the funds available for distribution. Both of these aspects are crucial to the development of an appropriate marketability discount for the valuation of a limited partner interest.

Why Normalizing Adjustments Should Be Made. A limited partner has virtually no control over such things as the management, distribution of cash flows, and investment strategy of the partnership. However, fair market value is defined as the price at which a hypothetical willing buyer and a hypothetical willing seller, both of whom are fully informed, neither of whom is under any compulsion, and both of whom have the capacity to engage in a transaction. Any hypothetical investor would anticipate a "normalized" level of income and a corresponding level of general partner compensation based on some industry norm.

Normalizing adjustments reveal the true investment characteristics that are the source of "potential value" to buyers of minority interests. When minority interests are purchased, investment judgments are made based upon how and when this potential value might ultimately be realized. Based on the timing and the amount of expected returns on illiquid minority interests, appraisers develop marketability discounts that are sufficient enough to consummate the hypothetical transaction.

It can be argued that because limited partners (or other similar minority investors) lack control to change things like general partner compensation or to negotiate property leases, normalizing adjustments should not be made. However, keep in mind that minority shareholders of public companies lack this discretionary ability as well. If unusual activity is occurring on the income statement, minority shareholders of the public company will find alternative investments and the price of the public company's stock will eventually reflect this.

Conclusion. Information should not be taken at face value. It must be examined and reconciled to a standard of reasonableness, common sense, and informed judgment. Our hypothetical partnership illustrates the importance of understanding the numbers and the necessity of normalizing adjustments. ◆

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