INTANGIBLE ASSETS

James P. Catty

In June 2001, FASB totally changed the rules for merger accounting by introducing the integrated structure of Statements of Financial Accounting Standards 141 and 142 to replace the venerable APB 16 and 17; SFAS 141 and 142 they were followed by SFAS 144 on long lived assets. Many practitioners are confused by their complexity, the new definitions and disclosure requirements. While there is much that has to be considered, this short article merely deals with Intangible Assets, concentrating on the valuation of two that are found in nearly every business: The Customer List and the name of the Business.

Intangible Assets

According to SFAS 141 and 142, an item is to be recognized as an Intangible Asset, other than Goodwill, if it:

- Arises from contractual or legal rights, even if it can-not be separated and/or sold on its own, or
- Is capable of being separated or divided, and sold, transferred, licensed, rented or exchanged regardless of in-tent, either individually or together with a related con-tract, asset or liability.

However, a trained workforce that qualifies under (2) and had, un-der APB 16, been treated as an Intangible Asset, now becomes part of Goodwill.

FASB, in SFAS 141, divides its examples of Intangible Assets into five classes:

1. Marketing-related
2. Customer-related
3. Artistic-related
4. Contract-based
5. Technology-based

We concur with some commentators, who add a sixth:

6. Statute-based, which includes licenses, permits etc., even though FASB treats them as part of the contract-based category.

This new definition and the related categories of Intangible Assets are rather different from the traditional division, as set out in "Valuation of Intangible Property and Intangible Assets", Smith & Parr, 1992:

Intangible Assets

Intangible Assets are all the elements of a business enter-prise that exist in addition to monetary and physical assets. They include:

- Rights
  - Contractual Rights, Rights of Franchisee and Franchiser
- Relationships
  - Customer Relationships, Distributor Relationships
- Grouped Intangibles
  - Going Concern Value, Goodwill
- Intellectual Property
  - Patents, Trademarks, Copyrights, Trade Secrets and Know-how

Fair Value

As well as changing the definition and categories of Intangible Assets, FASB also introduced a new concept, Fair Value. We are all familiar with Fair Market Value, as defined by the IRS in the Estate Tax Regulations and Revenue Ruling 59-60, which is:

> "The price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts".

Fair Value, as stated by SFAS 142, is:

> "The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale".

The difference, in essence, is that Fair Value relates to a specific, usually trade purchaser rather than to Fair Market Value's hypothetical generalized, normally investment buyer, and therefore includes the benefits of any synergy from integrating the business with that of the purchaser.

Valuation of Intangible Assets

The three standard valuation approaches, Income, Market and Cost, are all applied to Intangible Assets, although possibly in slightly unconventional ways. Under the Income Approach, two methods are commonly used, Royalty Savings and Discounted Cash Flow.

Income Approach

The Royalty Savings method is based on the benefits of owning, rather than licensing, the Intangible Asset and thereby avoiding royalties that otherwise would have to be paid. Its most difficult element is determining an arm's length royalty rate. The most satisfactory foundation for such rates is a proprietary licensing database, that list thousands of royalty rates compiled from numerous SEC filings and other public documents.

Licensing newsletters and publications, such as The Licensing Economics Review, are another important source. Additional information can be found in franchise guides; licensing and academic journals; court cases; SEC filings, and from owners of the same or similar Intangible Assets.

The Royalty Savings are determined by: (1) multiplying the related revenue by a suitable royalty rate; (2) deducting corporate tax, and then (3) capitalizing the amount at a rate reflecting the cost of the firm's equity funds, the expected growth and any asset-specific risks. The value of the Intangible Asset should also include the present value of benefits from amortization for tax purposes.

The traditional Discounted Cash Flow method is applied to an In-tangible Asset by estimating the after tax Cash Flows of the business related to that particular item for several years, and a Terminal Value if applicable. To give the Free Cash Flow, an annual capital charge is then deducted relating to the other financial, physical and intangible assets required for the activity. The worth of the Intangible Asset is the present value of the Free Cash Flows, and, if appropriate, a Terminal Value at an appropriate Discount Rate. This method is more complicated to apply than the Royalty Savings method, as shown in the example, but does not re-quire such detailed research.

Market and Cost Approaches

The Market and Cost Approaches are rarely used for Intangible Assets. The Market Approach requires information about actual transactions of similar items; this is often difficult to obtain, as comparability is (a) significant (issue) and there is limited available data.

Concerning the Cost Approach, for Intangible Assets, where there may be a "build or buy" alternative, it is desirable to establish their Replacement Cost, taking into account not only a profit for the builder, but also an amount to cover "time-to-market". Another way of applying it is to estimate the expenditures necessary to "design around" the particular Intangible Asset, allowing the use of an alternate. Although useful as a "reality check", the Cost Approach does not always result in Fair Market Value, nor Fair Value for Intangible Assets.

Reasonableness Test

All values for Intangible Assets must be subjected to one or more reasonableness tests because of the significant uncertainty in their determinations. Not only should multiple methods be used, but, for example, with the Discounted Cash Flow method, it is usually desirable to look at more than one scenario. The most important test is to compare the value to a benchmark by establishing the worth of the total business, either from Guidelines, or by capitalizing earnings. Deducting the financial and physical assets gives an implicit amount for the Intangible Assets. This then is allocated to all of them, adding the Going Concern Component, which is the workforce and other items required for an operating business that FASB includes in Goodwill.

Another test is to match the values of Intangible Assets as multiples of revenue with those disclosed for acquisitions of similar enterprises. A third test is to consider costs and time required to create a comparable intangible; a fourth is to look at the supply and demand of similar Intangible Assets and the cost to acquire them.

Finally, common sense, not to rule out a touch of intuition must always be applied to the results by adjusting the assumptions or the conclusions, based on the valuator's past experience and industry knowledge.

Customer Lists

Every Business has Intangible Assets; several published check lists identify more than 100 different types, but we concentrate on two owned by nearly every business: the name of the business and a Customer List. The latter is simply a database containing names, addresses and phone numbers of existing customers, usually with some information as to how active they are, the date of the last transaction and the total revenue generated for the past twelve months.

They are normally valued using the Discounted Cash Flow method. The first step is to determine the related Cash Flows. The easiest means of doing this is to estimate the revenue attributable to active, existing accounts, considering customer churn (turnover), and the ability of other data to confirm its reasonableness.

The next step is to deduct the direct costs for the transactions, including, product development (if applicable) and maintenance levels of selling, customer service, general and administrative expenses, to give a contribution Cash Flow margin. After deducting tax, the Net Cash Flow is reduced by a capital charge for all items, such as property, plant & equipment, working capital, brand name, existing technology and other intangibles required to operate the business. This may either be based on the carrying amounts of such items, or on a percentage of the Net Cash Flow. The final step is to convert these Cash Flows to a present value, which must be adjusted for the tax shield benefit.

As an example, consider a hypothetical drug store. Based on prescriptions filled, it shows a listing of 5,066 customers. After analyzing purchasing activity, it is determined that, due to moving away and deaths, the retention rate of customers in previous years has been: Year 1, 95%; Year 2, 75% of those 95%; Year 3, 50%; Year 4, 25% and Year 5, 10%. This means that out of 100 customers at the end of Year 1, there are 75 at the end of Year 2, 38 at the end of Year 3, 10 at the end of Year 4, and only 1 at the end of Year 5. Pretty abysmal, but I have experienced it.

The following table sets out the process of calculating the value of the Customer List:

		Projected			
	2002	**2003**	**2004**	**2005**	**2006**
Active Customers Year End	100	75	38	10	1
Average Customers	103	88	57	24	6
Revenue per Customer $	400	412	424	437	450
Revenue $	41,200	36,050	23,956	10,488	2,475
Cash Flow (18%) $	7,416	6,489	4,312	1,888	446
Income Tax (40%) on Cash Flow $	(2,966)	(2,596)	(1,725)	(755)	(178)
Net Cash Flow $	4,450	3,916	2,610	1,132	292
For Supporting Assets (56%) $	(2,492)	(2,193)	(1,462)	(634)	(164)
Free Cash Flow $	1,958	1,723	1,148	498	128
PV Factor (20%)	n.a.	0.9129	0.7607	0.6339	0.5283
PV Cash Flow $	n.a.	1,573	873	316	68
Total Present Values of Cash Flows $		2,830			
Tax Shield Benefits (15.82%) $		448			
Value of 100 Current Customers $		3,278			
Value per Customer (rounded) $		$32,75			
Value of Customer List (rounded)		166,000			

Brand Name

The second asset owned by every business is its name. Again, it would normally be valued by the Discounted Cash Flow method. In valuing the brand name, unlike the Customer List, all sources of revenue are included, and a royalty rate is obtained by looking at drugstore franchise agreements; the 1.2% chosen is based on that charged by a medium-size wholesaler.

Terminal Amount	**2002**	**2003**	**2004**	**2005**	**2006**
Total Revenues $	800,000	825,000	850,000	875,000	900,009
Profit (3.1%) $	24,800	25,575	26,350	27,125	27,900
Name Royalty (1.2%) $	9,600	9,900	10,200	10,500	10,800
Income Tax (40%) $	(3,840)	(3,960)	(4,080)	(4,200)	(4,320)
	5,760	5,940	6,120	6,300	6,480
PV Factor (20%)	n.a.	0.9129	0.7607	0.6339	3.7275
PV Cash Flow $		5,423	4,655	3,994	24,154
Total Present Values of Cash Flow $		38,226			
Tax Shield Benefits (15.82%) $		6,047			
		44,273			
Rounded $		44,000			

Note: The Terminal PV Factor assumes 3% growth indefinitely.

Conclusion

Traditionally, businesses have been valued on the income they generate; now, under SFAS 141 and 142, it has become imperative to also identify and directly value all Intangible Assets of a business. This is required, so that, when it is sold, the buyer can adequately allocate the purchase price among the various assets and properly account for the transaction. If this process is undertaken before the sale, the seller, the buyer, the accountant and the valuator can save themselves a lot of grief down the road.