

# CHAPTER 1

## Goodwill and Intangible Assets

The intellectual capital of an enterprise typically includes a portfolio of diverse intangible assets. These include the obvious patents, trademarks, copyrights, brand names, logos, and other elements frequently lumped into the category of goodwill and that are seldom valued individually. In addition, proprietary methodologies, best practices, application-specific software, operating systems, enterprise information infrastructures, as well as the tools to operate and support the information needs of a twentieth-first century business, comprise other intangible asset bundles that can contribute directly to return on equity and free cash flow. Their value, in terms of cash equivalences, is complex in composition and is heavily dependent on the context in which they are evaluated.

The range, type, and variety of intangible assets have continued to grow exponentially over the last two decades. In addition, the importance of protecting intellectual property such as trademarks, patents, and copyrights has also grown both in scope and complexity. For example, there were no “business method patents” two decades ago, nor had any trademarks been issued for a specific color, sound, or odor, all of which have been done today. These changes and other leading-edge issues are even more important in a merger and acquisition, corporate reorganization, or bankruptcy environment, where speed is often of the essence and accuracy of both identification and valuation is crucial.

### Defining Intangible Assets and Intellectual Property

One hears the terms “intellectual property” and “intangible assets” often (and often interchangeably) and many times we are asked what the differences are between these two terms. It is important to note that, in this handbook, the terminology, descriptions, definitions, and explanations are intended for the operating or in-house counsel—these definitions of key terms used in the pages of the book are not intended as legal definitions under USPTO<sup>1</sup> regulations or Generally Accepted Accounting Principals (“GAAP”), nor are they legal definitions under any specific area of the law, such as the Copyright Act or the Bankruptcy Code. In the pages that follow, we aim to provide basic, clear-cut explanations of those phrases, terms, and terminology that too often are used today without a clear understanding by all parties as to what is meant.<sup>2</sup> The best way to set out on this path of terminological clarification is to briefly describe three overlapping concepts: Intangible Assets, Intellectual Property, and Goodwill.

### Intangible Assets

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1. United States Patent & Trademark Office.

2. A much more comprehensive, although not exhaustive, glossary of intangible asset and valuation terms is available in Appendix A.

In general, the family of intangible assets is more inclusive than intellectual property and somewhat less ephemeral and more easily described and classified than goodwill. The terms below describe most intangible assets and most should share a majority of the following characteristics:

- the asset must be identifiable, both within the specific company or context, as well as identifiable in a general sense;
- the intangible asset can be legally owned;
- the birth and development of the intangible asset must be able to be traced;
- the intangible asset can be protected (this would include, of course, all intellectual property);
- there should be some proof of its existence in the form of a contract, registration, database, etc;
- the intangible asset has a lifespan that can be determined, and/or a specific lifespan that can be renewed (e.g., the renewal of trademarks every 10 years);
- the intangible asset has similar or comparable assets to be found elsewhere in the marketplace or in other companies; and
- the value of the intangible asset can be quantified.

The characteristics listed above are part of a legal definition, developed over time in various court cases. However, they also act as practical guidelines and characteristics to define what an intangible asset is. Perhaps the key concept to understand as we begin this discussion of intangible assets is that in order for an intangible asset to be recognized as such, it must have value in and of itself, and one must be able to quantify or measure that value.

Given that premise, the list of intangible assets can be narrowed. In the next several pages of this book, we have a fuller discussion of intangible assets, and an expanded list of intangible asset groupings and classifications. In the listings exhibit below (see Exhibit 1-1), we have listed some of the more important assets—but this is *not* intended as either an exhaustive classification of intangible assets, nor is it anywhere near a complete listing of intangible assets. While the list in Exhibit 1-1 is extensive, we wish to use it only as a starting point in order to illustrate the variety of types of intangible assets and the range of specific intangible assets inside each sub heading. As we move through this book, we will return to this list of intangible assets and the grouping or bundling of assets; and we will discuss how intangible assets can and should be bundled and valued, and the maximum value being extracted from them via sale, joint venture, license, etc.

### **EXHIBIT 1-1**

#### **Partial List of Intangible Assets**

## **1. Marketing-Related**

- Trademarks and service marks
- Trade names
- Brand names
- Logotypes
- Colors

## **2. Technology-Related**

- Design patents
- Process patents
- Patent applications
- Business method patents
- Technical documentation (e.g., laboratory notebooks, technical know-how)

## **3. Artistic-Related**

- Literary works and copyrights
- Musical compositions
- Photography
- Maps
- Engravings

## **4. Data Process-Related**

- Platform software
- Software copyrights
- Automated databases
- Integrated circuit masks and masters

## **5. Engineering-Related**

- Industrial designs
- Trade secrets
- Engineering drawings and schematics
- Technical know-how
- Blueprints

## **6. Customer-Related**

- Customer lists
- Customer contracts
- Customer relationships
- Open purchase orders

#### **7. Contract-Related**

- License agreements
- Franchise agreements
- Operating licenses
- Subscription rights
- Futures contracts

#### **8. Human Capital-Related**

- Trained workforce and wages
- Union contracts
- Employment Contracts

#### **9. Location-Related**

- Mineral exploitation rights
- Easements
- Air rights
- Water rights

#### **10. Internet-Related**

- Domain names
- URLs
- Linkages
- Website design

Intangible assets are often confused with the concept of goodwill. Goodwill encompasses all of the non-tangible assets of a company or organization. On the other hand, intangible assets refer specifically to those things of value that are not tangible but can be measured and managed and to which a value may be attached. For example, the concept of a company's "good reputation" is a concept embedded in goodwill; whereas "corporate brand value" is a specific intangible asset that can be measured and valued.

Other listings and categorizations of intangible assets have been put together by various authors and experts in the field. For example, in its latest addition, *Valuing*

*Intangible Assets* by Reilly & Schweih, <sup>3</sup> lists even more intangible assets. It divides the assets into 10 groupings, loosely arranged by the similarity in nature of the intangible assets listed.

No listing of intangible assets can be exhaustive, since meaningful, measurable intangible assets are continuously being created. A decade ago, website design might well have not been classified as an intangible asset with value. Today, it is an important element of many companies' operations. Years ago, retail relationship assets might not have been classified as a specific intangible; today, exclusive contracts between manufacturers and suppliers with particular retailers have become increasingly important. For example, an exclusive contract from Footstar Corporation to supply Thom McAn shoes to Kmart is a classic sample of a very valuable intangible asset. Similarly, an exclusive contract for a manufacturer-importer of basic unbranded garden tools to be supplied to Target stores is a valuable intangible asset. If that contract has a definable life and some sort of exclusivity, it can be an important intangible asset. The following examples illustrate that one must look below the surface to identify intangible assets that are specific to the company or situation:

- Entertainers like Neil Diamond and Celine Dion perform on a periodic and predictable basis. These contracts are intangible assets and clearly have substantial value to the hotels or nightclubs with which they are affiliated.
- Contracts to cook and distribute meals and provide supplies in Iraq are unique intangible assets and are of great value.
- The exclusive rights to drill and explore for oil and gas in the Gulf of Mexico or Alaska, under contract with various governments, are also valuable and unique intangible assets.
- Drug companies conduct research and collect proprietary test data on their proprietary drugs, and all of this data and research is identifiable and considered to be valuable intangible assets.

### **Intellectual Property**

Intellectual property often has the greatest and most realizable value including trademarks, copyrights, domain names, and quantity.

Intellectual property is in many ways a subset of the larger family of intangible assets. A piece of intellectual property is, in fact, an intangible asset, but it is a unique intangible asset because it has a very important difference: formal legal protection has been granted. Intellectual property falls into a very small group of definable assets:

- Trademarks, trade names (both registered and unregistered), and service marks

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3. ROBERT F. REILLY & ROBERT P. SCHWEIHS, VALUING INTANGIBLE ASSETS (McGraw-Hill 1999).

- Patents
- Trade secrets and proprietary technology
- Copyrights
- Domain names
- Software and mask works

It is crucial to understand that pieces of intellectual property are often supported by other intangible assets—or bundled together with—other intangible assets. In simplest terms, bundling means that two or more pieces of intellectual property and/or intangible assets support one another and are considered for valuation purposes to be traveling together, e.g., a trademark and its associated trade dress.

Bundling of assets is a concept that is perhaps as old as man's desire to accumulate things or objects. However, when used in the context of intangible assets and intellectual property, it refers specifically to organizing intangible assets into their logical groupings—groupings are bundles that reflect how these assets work together and travel together. Later in this chapter, we will address bundling in more detail.

Nonetheless, it is useful to at least remember that trademarks, copyrights, patents, and domain names are all protected by specific laws, as is software. In fact, software can be protected as a copyright or as a patent. The trademark act, the copyright act and patent law protects each of these. Domain names are protected under the Domain Name Act of 2003.

This handbook does not address the full spectrum of legal issues in this area. Therefore, we will not cover in detail how specific pieces of intellectual property come into existence, (e.g., trademarks or patent registrations). Instead, we will focus on the identification, analysis, and value extraction from these intangible assets. A critical point must be understood by the reader, since it will carry all the way through the balance of this handbook:

This handbook uses the terms “intangible assets” and “intellectual property” as synonyms and substitutes for each other, and the term “intangible asset” should be understood to be used universally within the handbook to encompass traditional intellectual property.

## **Goodwill**

The concept of goodwill has been around probably as long as formal accounting systems have been in place, going back probably to the Phoenicians. A variety of definitions of goodwill have evolved over the last two centuries. However, these attempts have been surprisingly unable to capture a comprehensive definition of the term once and for all and in all situations. In the pages to follow, we'll examine some of the definitions and descriptions of goodwill.

How does one best define goodwill in a legal context? The Federal Accounting Standards Board has issued relatively new regulations that consider new accounting

treatment of several of the assets that were historically included in the definition of goodwill. SFAS 142, *Goodwill and Other Intangible Assets*, superseded Opinion 17, which called for the amortization of goodwill over a period not to exceed 40 years. SFAS 142 does away with goodwill amortization and provides for a periodic (annual in most cases) impairment test instead. Rather than lump amounts above and beyond the value of the physical and monetary assets into a catch-all “goodwill” account, SFAS 142 distinguishes between intangible assets that are finite-lived (e.g., patents and copyrights) and those that are indefinite-lived (e.g., goodwill and many trademarks). According to FASB, then, goodwill is currently defined as the portion of the purchase price that is above the value of all assets that can be categorized (tangible and intangible).<sup>4</sup>

Other definitions have defined goodwill in different ways:

- In earlier common practice in the United Kingdom, the British defined goodwill as the probability that an enterprise’s customers or patrons would continue to do business with it, and value its products and services above those available from other companies or purveyors.
- In the United States, goodwill specifically attaches to a piece of intellectual property (e.g., trademark). For example, U.S. courts have ruled that a trademark cannot continue to maintain its value or uniqueness apart from its goodwill and that the goodwill of a particular trademark or a particular brand is always linked with the trademark that describes that brand. This, however, is not the case in all international venues.
- The American Institute of Certified Public Accountants (AICPA) has described goodwill as all those intangibles and supporting assets that contribute to the advantage that an established business has over a comparable business that is about to be started—in other words, image, customer base, reputation, perceptions, etc.<sup>5</sup>
- Both the FASB and IASB organizations have adopted the same definitions of goodwill by its nature not its measurement: At acquisition date, the acquirer recognizes goodwill acquired in a business combination as an asset. The asset recognized is measured as the excess of the cost of acquisition over the acquirer’s interest in the fair values of assets, liabilities, and contingent liabilities acquired. Subsequent to initial recognition goodwill is measured at cost less any accumulated impairment losses recognized in accordance with IAS 36 (the relevant requirements of IAS 36 are discussed in Chapter 3).<sup>6</sup>

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4. See FASB Regulations and Definitions.

5. See AICPA Regulations and Definitions.

6. FASB Board Meeting Minutes, December 1, 2004—A Guide to IFRS 3, *Business Combinations*.

Goodwill itself is not specifically identified as a separate intangible asset or piece of intellectual property, except as called for by SEC<sup>7</sup> or FASB accounting regulations. In simplest terms, goodwill in a company balance sheet is that amount of value in excess of the other assets that can be measured—both tangible assets and intangible assets—as shown in Exhibit 1-2.

In the Exhibit 1-2, we have constructed a very simple example of how a company's total asset portfolio might be presented. This is intended as a general overview of tangible and intangible asset accounting, and it is structured to reflect what actually happens (albeit in a much simpler form) when one reviews the balance sheets of small and large corporations alike. Further, one must be careful when reviewing the exhibit to not jump to the conclusion that goodwill is a fungible or easily manipulated number. Indeed, in a publicly traded company, it is a very specific number. The calculations of those specific numbers for goodwill are most simply summarized in layman's terms as follows:

**Total stock market value—value of tangible assets—value of intangible assets = remainder ascribed to goodwill.**

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7. U.S. Securities and Exchange Commission (the agency responsible for administering federal securities laws in the U.S.).

## EXHIBIT 1-2

### Goodwill Quantified

<b>Publicly Traded Manufacturing Company</b>	<b>Values</b>
Total value based on the stock price multiplied by the number of shares	\$500M
Less tangible asset values as determined by professionals (plant and equipment)	\$300M
Less value attributed to trademarks based on professional valuation	\$ 50M
Less patent, copyright, and software value as determined by professionals	\$ 50M
<b>Balance Left to Goodwill</b>	<b>\$ 100M</b>

In valuing asset groups, there are three generally accepted methods that are used:

- Cost Method;
- Income Method; and
- Market Method

These methodologies are in general applicable and adaptable to both tangible and intangible assets. Further in this handbook we will describe in greater detail the various methodologies and how they are applied to intangible assets.

### **Other Intangible Asset Definitions**

The definitions and categorizations of intangible assets provided by FASB<sup>8</sup> are not necessarily reflective of market conditions or even what we would consider to be standard marketplace definitions of intangible assets. They are, instead, an artificial construct developed by a special panel that met for many years to determine how best to deal with the issues of intangible assets in a merger or acquisition. These definitions and regulations for accounting in mergers came as a result of heavy merger and acquisition activities in the 1980s and 1990s. Until 2001, the “pooling method of accounting” was available for use, under which nothing had to be valued in the acquisition of another company. In other words, a company purchasing another company would buy all of the assets and bury any excess overpayment for those assets in the books of the combined company. The result was that few could really understand corporate financial statements or asset values of the newly combined company. Accordingly, the value of the acquired

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8. Federal Accounting Standards Board.

intangibles, which was quite large in a number of cases, was hidden in the “pooling” actions or otherwise not evident.

This, combined with the corporate scandals of the late 1990s and early 2000s, brought about not only new FASB regulations but also the passage of the Sarbanes-Oxley Act. Exhibit 1-3 lists all of the intangible asset classes that these regulations address. For purposes of merger and acquisition accounting, all intangible assets have to fall into one of these five groups. This can be artificially constricting in a merger business or other business environment but obviously useful under FAS 141, 142, and 144 of the FASB guidelines.

### **EXHIBIT 1-3**

#### **Intangible Assets That Meet the FASB Criteria for Recognition Apart from Goodwill**

##### **I. Marketing Related Intangible Assets**

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

##### **II. Customer Related Intangible Assets**

- Customer lists
- Order or production backlog
- Customer contracts and related customer relationships
- Non-contractual customer relationships

##### **III. Artistic Related Intangible Assets**

- Plays, operas, ballets
- Books, magazines, newspapers, other literary works

- Musical works such as compositions, song lyrics, advertising jingles
- Pictures, photographs
- Video and audiovisual material, including motion pictures, music videos, television programs

#### **IV. Contract Based Intangible Assets**

- Licensing, royalty, standstill agreements
- Advertising, construction, management, service or supply contracts
- Lease agreements
- Construction permits
- Franchise agreements
- Operation and broadcast rights
- Use rights such as drilling, water, air mineral, timber cutting, and route authorizations
- Servicing contracts such as mortgage servicing contracts
- Employment contracts

#### **V. Technology Based Intangible Assets**

- Patented technology
- Computer software and mask works
- Databases
- Trade secrets, such as secret formulas, processes, recipes

### **Intangible Asset Regulations and Organizations**

In addition to the laws and rules discussed above, we also have the following regulations:

- IRS regulations of 2004, which address capitalization of intangible assets;

- IRS regulations as to offshore intellectual property holding company rules;
- state regulations as to intellectual property holding companies;
- SEC rules as to accounting and reporting of intangible asset values and revenues;
- FASB sections 141, 142, 144;
- Generally Accepted Accounting Principles (GAAP);
- UCC regulations and common law;
- USPTO registration and ownership registrations; and
- for multinational corporations, the newly developed (2002) IASB standards and international financial reporting regulations.

All of these have some impact on corporate portfolios as well as individual intangible assets, and the impact at least needs to be understood in the context of any deal, bankruptcy, or securitization. Further, it is important to know that there are a number of groups that specialize in intellectual property and have an influence over regulation, use, registration, litigation, management, etc. Among them are groups as diverse as:

- The International Trademark Association, INTA ([www.inta.org](http://www.inta.org))
- The International Licensing Executive Society, LESI ([www.lesi.org](http://www.lesi.org))
- The American Intellectual Property Law Association, AIPLA ([www.aipla.org](http://www.aipla.org))
- The Association Internationale Pour Le Protection de Propriete Intellectual, AIPPI ([www.aippi.org](http://www.aippi.org))
- The World Intellectual Property Organization, WIPO ([www.wipo.org](http://www.wipo.org))
- The Licensing Industry Merchandisers Association, LIMA ([www.licensing.org](http://www.licensing.org))
- The American Bar Association, ABA, and its sections and committees on intellectual property ([www.abanet.org](http://www.abanet.org))
- The Intellectual Property Owners group, IPO ([www.ipo.org](http://www.ipo.org))
- Association of Corporate Patent Counsel

### **Intangible Asset Value and Value Identification**

Valuation of intangible assets is crucial in many situations. Since accurate values are critical, it is necessary to first address two core issues. First, identify the underlying cause (e.g., a Chapter 11 filing or an impending transaction) that precipitated the need to value the assets. Second, identify the basic premise of the valuation (e.g., going-concern or liquidation value). One can then establish the then-current market value of the intangible assets, given the conditions and valuation goals—the context of value.

Valuing intangibles follows much the same pattern each time, with a few key differences.

- First, identify all the intangibles involved and group them into bundles (See Chapter 3).
- Second, separate those intangibles from the tangible assets so that a stand-alone valuation can be established.
- Third, identify incremental value within the family of intangibles, looking for additional financial security and/or financial leverage. The goal is to identify all of the intangibles and their potential uses that have market value.

Valuation is context-specific, meaning that different characteristics for the intangible assets and how they are used will result in different values. For example, assets associated with a large company that has an existing distribution network will have a different value from a small operation that has yet to offer a product for sale. This is primarily due to the complementary factors involved, such as skilled labor, abundant capital, an effective marketing program, greater manufacturing capacity, and proven distribution channels. The same intangible asset may have different values when viewed in the context of a large corporation, a joint venture, or a company going through reorganization because the complementary factors are likely different from one scenario to the next. As mentioned above, an important part of identifying the context is determining which assets are to be included in the analysis. In addition to the patents, trademarks, and copyrights, there may be other related intangibles that can have a very real impact on the firm's success. Among these are trade dress, logos, trade secrets, know-how, and formulae.

Value identification and quantification becomes a four step process.

- The first step is to determine the context of value: why are the assets being valued and for whom?
- The second step is to appropriately identify the assets, both primary assets and their accompanying intangibles.
- The third step is to complete the asset analysis by bundling similar assets that travel together into groups.
- The fourth step is to employ the proper methodology. Chapter 4 of this handbook deals at length with valuation methodologies, both in theory and in practical applications.

In addition, the case studies at the end of the book deal with substantial issues of valuation.

## **Conclusion**

Intangible assets definitely are a unique class of business (and often personal) wealth and competitive advantage. The world of intangible assets is indeed a special world.

- This is indeed the age of the intangible asset economy, and unquestionably their role, breadth, and value will continue to increase in the industrialized world as well as in second and third world economies.
- The world of intangible assets changes quickly and much has changed just since the year 2000—categories of assets, accounting roles, definitions of intangible assets, as well as the change in the ability to securitize and use these assets as a financial basis in many companies.
- Defining and differentiating intangible assets in intellectual property is sometimes difficult since all intellectual properties are intangible assets, but not all intangible assets are intellectual property.
- Finally, the concept and definition of goodwill is sometimes difficult to grasp, often difficult to understand, and constantly changing. Perhaps goodwill is best described as that value within a company that is left over after all other assets, both tangible and intangible, have been accounted for and accurately valued.