The Financial Valuation Group®

Forensic Accounting, Business Valuation and Consulting

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Collaborative Law and Transparency

While Collaborative Law has been around for years, it has been relatively overlooked outside the area of family law—until recently. Many collaborative law groups across the U.S. are interested in establishing rules for the collaborative law process in family law. But there are some practitioners who believe Collaborative Law can be practiced for all types of legal issues, including shareholder disputes and business damages. The key? Collaborative Law must build a framework for transparency.

Michael Mard, CPA/ABV/CFF, ASA, has begun a series of articles on this topic (see page 3 for an excerpt from the first article in this series). The first article proposes rules for collaboration. The second carries this topic forward to the use of experts. These articles can be downloaded from The Financial Valuation Group's web site at www.FVGFL.com. Visitors may also subscribe to FVG's e-blast and receive forthcoming articles directly in their inbox as they are published.

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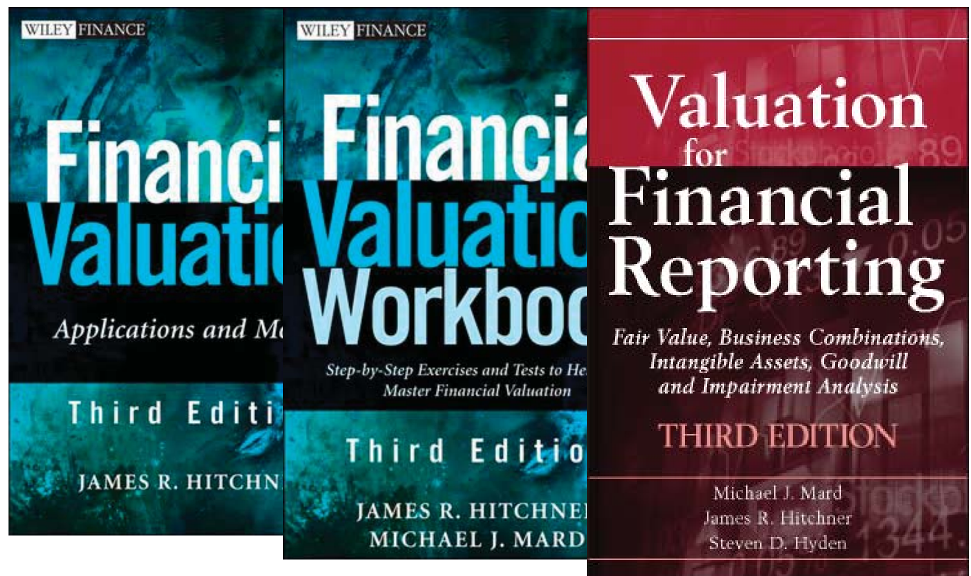

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Valuation of Trade Names and Similar Intangible Assets

by Michael A. Crain, CPA/ABV, ASA, CFA, CFE

Despite economic conditions and a slowdown in merger and acquisition activity, there's still a demand for valuations of trade names and similar intangible assets. We see the need for such valuations coming especially in financial reporting from business combinations and litigation such as bankruptcy. In these circumstances, individual assets need to be valued separately instead of an entire business enterprise as a whole. In this article I discuss some principles of valuing trade names and similar intangible assets.

The three main approaches to value any investment asset are market, income, and cost. I won't go into the details of these approaches as much has been written about them over the years in many publications. In intangible asset valuation, it's virtually impossible to find 'comparable sales' to observe prices that might serve as valuation benchmarks. We usually can't observe the prices of intangible assets B, C, and D to estimate the value of A. Thus, the market approach is usually impractical for these kinds of assets. The cost approach is often dodgy to determine market value as we intuitively know that simply because you pay to build something doesn't necessarily mean it has value to anyone else. Software is a common example. A lot of software has been written—at a cost to someone—that is worthless because few buy it.

That leaves the income approach. Simply put, this approach estimates the value of an asset based on the cash flows that are expected to be derived from owning it, discounted to the present value. A simple example is a bond that will pay you interest periodically plus the bond's face value at maturity. The value of your bond today is the present value of those expected cash flows.

Without getting into multiple valuation methodologies, a common approach to value trade names and similar intangible assets is the 'relief-from-royalties method.' The logic of this method is that if a firm did not own the intangible asset, it would have to license it and pay royalty costs. Such costs would lower the firm's profits. But by owning the asset, the firm does not incur these costs and its profits are higher. Simply put, the relief-from-royalty method is the present value of future royalties a firm avoids by owning the intangible asset.

The mechanics of this method are (1) estimate a firm's future sales of goods or services associated with the asset, (2) estimate a market royalty rate associated with the particular intangible asset, (3) multiply the results of the first two steps to calculate future royalty costs on a year-by-year basis, which a firm avoids by owning the asset, and (4) discount those future royalties to a present value.

The most important aspects of this methodology are estimating a firm's future sales, a market royalty rate for the asset, and a discount rate for the present value calculations. In practice, historical financial statements often serve as a basis for estimating a firm's future sales. When valuations of these kinds of intangible assets are done for financial reporting and litigation, any significant deviations from a firm's historical sales and trends need to be justified to auditors and triers of fact. Secondly, reasonable royalty rates on a particular asset are often estimated by observing royalty rates derived from actual licensing agreements of comparable assets. This typically requires research to find licensing data and reviewing the licensing information. Third, a discount rate to calculate the present value is essentially based on the intuitive relationship between risk and return, which is described extensively in the finance literature. Simply put, investors require higher rates of return (a/k/a discount rate) as an incentive to buy assets with risky cash flow expectations. Since intangible assets are not traded in the market, we cannot directly observe rates of return of these kinds of assets. The practical challenge is quantifying the magnitude of a particular asset's discount rate. This process normally involves observing rates of return of other kinds of assets in the capital markets and then calibrating those rates to a particular asset's degree of risk. If we're observing market rates of return for assets with lower risks than a particular intangible asset, logic and experience tells us that investors require a higher rate of return than the observed rates. Judgment is necessary in calibrating market rates of return to rates for intangible assets.

We come across situations where someone believes that simply by owning legal rights to a trade name or other kind of intangible asset such as patents necessarily means it has value. Intuition tells us that we would not remove our funds from savings to pay for legal rights having little or no expectation of giving us any profits. Profit expectations are fundamental for driving value among rational investors. Thus, one of the first questions we ask in assessing whether these kinds of intangible asset have any value is whether there are reasonable expectations of profits. The challenging part of this kind of assessment is separating the profits of an operating enterprise between a particular intangible asset and other assets the firm uses in its operations.

In summary, trade names and similar intangible assets have market value if there are expectations that they will generate profits for the owner. If there are, we estimate those profits into the future by collecting data and financial analysis. Next, we observe royalties of licensing negotiations to estimate a reasonable royalty a particular intangible asset ought to have. This gives us royalties associated with an intangible asset as if it were licensed. The last step is to calculate the present value of these royalties. ~~

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Transparency in Collaboration

by Michael J. Mard, CPA/ABV/CFF, ASA

Collaboration in litigation requires transparency, but what is transparency?

COLLABORATIVE LAW

Collaborative law is a process of alternative dispute resolution in which the opposing parties:

- Agree to the voluntary and free exchange of information;
- Pledge to avoid traditional litigation in the court room; and
- Commit to shared solutions and final resolutions.

The collaborative process is a focused settlement process and is framed by an upfront written Collaborative Law Agreement that sets forth the process and goals. It is similar to mediation with one key difference—there is often no mediator. Collaborative law (and the collaborative process) is applicable to all manner of disputes, including family law (perhaps the most frequent), shareholder disputes, commercial damages, contract disputes, lost profit disputes, intellectual property disputes (patents, trademarks and copyrights), personal injury, employment disputes, eminent domain, malpractice, and many other types.

Many web sites and articles related to the collaborative process reference an ubiquitous "open communication and information sharing" mantra in some form or another; yet this mantra is rarely if ever defined. This brings me back to my original question—what is transparency?

TRANSPARENCY

Simply stated, a process is transparent if it can be seen through easily, "just as one can see easily through a clean window." The transparent process must be readily understandable, and the scope of its derivative rights and obligations must be easy to assess for each party. Otherwise, it is opaque.

How is this openness to be accomplished? What are the guidelines assuring such openness? What specific processes can the parties follow to confirm transparency?

Grant Thornton, an international accounting firm, recently conducted a survey about transparency among business executives. The firm:

> ...asked survey respondents to define transparency for government financial and performance information. Here are their chief principles for such transparency, which apply to both the public and government users:
>
> - Have a process for ensuring that data you disclose are accurate and reliable, and show that process to users.
> - Understand the information that people want, and deliver it.
> - Be as open as possible without creating risk.
> - Provide information that helps make decisions.
> - Do not just react to requests – active outreach is important.
> - Give context to data: show goals, benchmarks and other information with which to compare them.
> - Take action yourself based on the information, and tell people what you did.
> - Be conscious of the dollar cost of transparency, and invest wisely in it.

How can these eight transparency principles be applied to the collaborative process? What are the specific principles of transparency related to business valuations and financial analyses performed in a collaborative process setting?

GENERAL PRINCIPLES

While financial analyses and business valuations may be performed by non-Certified Public Accountants, the CPA General Standards should be adopted as part of any Collaborative Law Agreement Supplemental where financial analyses are required. In fact, these principles are properly applicable to all collaborative professionals. These general principles are:

- Undertake only those services that the practitioner can reasonably expect to be completed with professional competence.
- Exercise due professional care in the performance of services.
- Adequately plan and supervise the performance of services.
- Obtain sufficient relevant data to afford a reasonable basis for conclusions and findings.

SPECIFIC PRINCIPLES

In addition to the general principles outlined above, specific principles of transparency applicable to a financial analyst (including a business valuator) working in a collaborative process should be adopted. These specific principles are designed to allow the verification, reproduction, and evaluation of findings and conclusions and are summarized here:

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Transparency (Continued)

- Clarity of scope of roles, responsibilities, and objectives
- Open process for formulating reporting
- Public availability of information;
- Accountability and assurance of integrity
- Shared vocabulary
- Benchmarking or verification of work performed
- Fees based on time and materials.

CONCLUSION

General and specific principles must be adopted to assure transparency of the work performed by a financial expert in a collaborative process. There has been much talk about transparency, but the time for general discussion must come to an end. While the principles I've outlined are preliminary, they are intended to form a basis for specific discussion and development. ~~

Editor's Note: This article has been shortened to fit the space provided. For the full text of the article, please visit www.FVGFL.com.

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