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***Intangible Assets:  
Identification, Valuation  
& Controversial Issues***

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***Intangible Assets:  
Identification, Valuation  
& Controversial Issues***

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INTRODUCTION

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## *Intangible Assets: Identification, Valuation & Issues*

### INTRODUCTION

- **Public corporations: 70-80% of value from intangible assets**
- **Privately-held companies likely following the same trend of movement from “hard” to “soft” assets**
- **Imperative for financial and legal advisors to understand the value of these assets and the resultant importance to clients**

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## *Intangible Assets: Identification, Valuation & Issues*

### INTRODUCTION

- **Understanding Different Types and Character of Intangibles**
- **Intangible Asset Valuation Process**
- **Commonly-Accepted Valuation Methodologies for Intangibles**
- **Court Cases Addressing Intangible Asset Valuation**
- **Conclusion and Practical Considerations**

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## *Intangible Assets: Identification, Valuation & Controversial Issues*

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UNDERSTANDING THE DIFFERENT TYPES  
& CHARACTER OF INTANGIBLE ASSETS

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### *Intangible Assets: Identification, Valuation & Issues*

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#### TYPES & CHARACTER OF INTANGIBLE ASSETS

- **Two main characteristics of intangible assets:**
  - *They lack physical existence*
  - *They are not financial instruments*
  
- **Normally classified as long-term assets**

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## *Intangible Assets: Identification, Valuation & Issues*

### TYPES & CHARACTER OF INTANGIBLE ASSETS

- **Five major categories of intangible assets**
  - *Marketing-related*
  - *Customer-related*
  - *Artistic-related*
  - *Contract-related*
  - *Technology-related*



## *Intangible Assets: Identification, Valuation & Issues*

### TYPES & CHARACTER OF INTANGIBLE ASSETS

- **Marketing-related**
  - *Used primarily to market or promote products or services*
  - *Enhance value of business by supporting marketing activities and creating or preserving a competitive advantage*
  - *Examples:*
    - Trademarks, trade names, newspaper mastheads, Internet domain names, non-competition agreements



## *Intangible Assets: Identification, Valuation & Issues*

### TYPES & CHARACTER OF INTANGIBLE ASSETS

- **Customer-related**
  - *Occur as a result of interactions with outside parties*
  - **Examples:**
    - Customer lists, order or production backlogs, and contractual and non-contractual customer relationships



## *Intangible Assets: Identification, Valuation & Issues*

### TYPES & CHARACTER OF INTANGIBLE ASSETS

- **Artistic-related**
  - *Involve ownership rights protected by copyrights*
  - **Examples:**
    - Plays, literary and musical works, photographs, video and audiovisual material



## *Intangible Assets: Identification, Valuation & Issues*

### TYPES & CHARACTER OF INTANGIBLE ASSETS

#### ▪ **Contract-related**

– *Represent the value of rights that arise from contractual arrangements*

– Examples:

- Franchise and licensing agreements, construction permits, broadcast rights, service or supply contracts



## *Intangible Assets: Identification, Valuation & Issues*

### TYPES & CHARACTER OF INTANGIBLE ASSETS

#### ▪ **Technology-related**

– *Relate to innovations or technological advances*

– *Often protected by patents (product and process)*

– *Intellectual property is specialized (created by specific human intellectual capital, rather than in normal course of business)*

– Examples:

- Patents, trade secrets, copyrights, trademarks



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## *Intangible Assets: Identification, Valuation & Controversial Issues*

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### INTANGIBLE ASSET VALUATION PROCESS

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## *Intangible Assets: Identification, Valuation & Issues*

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### INTANGIBLE ASSET VALUATION PROCESS

- **Intangible asset – must be subject to ownership and have value**
- **Determining value of intangible assets**
  - *Generally higher rates of return than tangible assets*
  - *Inherently more risky than tangible assets*
- **Appropriate discount rate determined based on above factors**

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## *Intangible Assets: Identification, Valuation & Issues*

### CALCULATION OF EXCESS EARNINGS METHOD

	<i>Net Asset Value</i>	<i>R.O.R.</i>	<i>Return On</i>
Working Capital	\$ 1,000,000	6.00%	\$ 60,000
Fixed Assets	\$ 2,000,000	10.00%	\$ 200,000
Debt Free Cash Flow			\$ 500,000
Less: Cash Flow Return to Tangible Assets			(260,000)
Cash Flow Return to Intangible Assets			240,000
Intangible Asset Rate of Return			25%
Value of Intangible Assets			<u>\$ 960,000</u>
Value of Net Tangible Assets			\$ 3,000,000
Value of Intangible Assets			960,000
FMV of a 100% Controlling, Marketable Interest			<u>\$ 3,960,000</u>

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## *Intangible Assets: Identification, Valuation & Issues*

### INTANGIBLE ASSET VALUATION PROCESS

- **Purposes of the intangible asset valuation**
  - ***Transactional***: contemplate a commercial transaction with an exchange of economic consideration
  - ***Notional***: do not contemplate a commercial transaction
- **Numerous reasons to conduct intangible asset appraisal or economic analysis, including accounting mandates**

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## ***Intangible Assets: Identification, Valuation & Issues***

### INTANGIBLE ASSET VALUATION PROCESS

- **Intangible asset appraisal process**
  - *Identification of asset*
  - *Collection and analysis of data*
  - *Consideration and application of valuation approach(es)*
    - Cost approach, income approach and/or market approach
  - *Conclusion of value*

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## ***Intangible Assets: Identification, Valuation & Issues***

### INTANGIBLE ASSET VALUATION PROCESS

- **Standard of value – tells to whom the value estimate applies**
  - *Fair market value*
  - *Fair value*
  - *Market value*
  - *Acquisition value*
  - *Use value*
  - *Investment value*
  - *Owner value*
  - *Insurable value*
  - *Collateral value*
  - *Ad valorem value*

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## ***Intangible Assets: Identification, Valuation & Issues***

### INTANGIBLE ASSET VALUATION PROCESS

- **Valuation date – “as of” date for determination of value**
  - *Historical*
  - *Contemporaneous*
  - *Prospective*



## ***Intangible Assets: Identification, Valuation & Issues***

### INTANGIBLE ASSET VALUATION PROCESS

- **Legal rights subject to appraisal**
  - *Must identify specific bundle of legal rights connected with ownership of subject intangible asset*
  - *Selection of the bundle of legal rights to be appraised has direct impact on value*



## ***Intangible Assets: Identification, Valuation & Issues***

### INTANGIBLE ASSET VALUATION PROCESS

- **Highest and best use analysis**
  - *Should be lawful*
  - *Should be physically possible*
  - *Generates positive economic return*
  - *Generates greatest value of all remaining alternative uses*



## ***Intangible Assets: Identification, Valuation & Issues***

### INTANGIBLE ASSET VALUATION PROCESS

- **Alternative premises of value – highest and best use analysis determines which premise should be applied**
  - *Value in continued use as part of going-concern enterprise*
  - *Value in place, but not in current use, in production of income*
  - *Value in exchange (part of an orderly disposition)*
  - *Value in exchange (part of a forced liquidation)*



## ***Intangible Assets: Identification, Valuation & Issues***

### INTANGIBLE ASSET VALUATION PROCESS

- **Data collection and third-party sources**
  - *Numerous documents needed from subject company in order to form an opinion of value*
  - *External, third-party sources can also be used*



## ***Intangible Assets: Identification, Valuation & Issues***

### INTANGIBLE ASSET VALUATION PROCESS

- **Interviewing intangible asset owner**
  - *Speaking firsthand to the owner and/or seeing the business operate can aid an appraiser in conclusion of value*



## *Intangible Assets: Identification, Valuation & Issues*

### INTANGIBLE ASSET VALUATION PROCESS

- **Useful life analysis**
  - *Conditions that lead to retirement, attrition or withdrawal:*
    - Physical, functional, operational and economic
  - *Factors to analyze in connection with estimating useful life:*
    - Legal, contractual, judicial, physical, technological, functional, economic and analytical
  - *Qualitative and quantitative analyses used in determination*

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## *Intangible Assets: Identification, Valuation & Issues*

### INTANGIBLE ASSET VALUATION PROCESS

- **Basic valuation approaches and methods**
  - *Cost Approach*
  - *Income Approach*
  - *Market Approach*

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## ***Intangible Assets: Identification, Valuation & Issues***

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### INTANGIBLE ASSET VALUATION PROCESS

- **Valuation synthesis/conclusion of value**
  - *Appraiser must look at calculations of value under all three approaches to arrive a final value estimate*
  - *Professional judgment is key component in reconciling values*
  - *Use of multiple approaches and methodologies can confirm value and provide credibility if challenged*

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## ***Intangible Assets: Identification, Valuation & Controversial Issues***

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VALUATION METHODS – COST APPROACH,  
MARKET APPROACH & INCOME APPROACH

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – COST APPROACH

- **Based on economic principle of substitution: value equals the cost incurred to develop a new, substitute asset**
- **Two primary methods of valuation**
  - *Reproduction Cost – New (identical asset)*
  - *Replacement Cost – New (asset with same functional utility)*



## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – COST APPROACH

- **Four broad categories of costs to consider**
  - *Direct development costs*
  - *Indirect costs*
  - *Profit to the developer*
  - *Opportunity cost*



## *Intangible Assets: Identification, Valuation & Issues*

### VALUATION METHODS – COST APPROACH

- **Adjustments for decrease in value**
  - *Physical deterioration (not usually applicable to intangibles)*
  - *Functional obsolescence*
  - *External obsolescence*



## *Intangible Assets: Identification, Valuation & Issues*

### VALUATION METHODS – COST APPROACH

- **Remaining useful life analysis**
  - *Determination of useful life allows for an estimate of the total amount of obsolescence that must be subtracted from the cost*
  - *Complex undertaking, with numerous influences which must be analyzed and quantified*





## *Intangible Assets: Identification, Valuation & Issues*

### VALUATION METHODS – COST APPROACH

- **Best applications for use in valuing intangible assets**
  - *Asset is relatively new or has been recently developed*
  - *Historical cost/development data is available from the owner*
  - *Owner/operator has expertise to allow for estimation of the asset's current cost, remaining useful life and obsolescence*
  - *Assets are used in the production of income, but do not independently generate any income*

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## *Intangible Assets: Identification, Valuation & Issues*

### ILLUSTRATION OF COST APPROACH

	<i>Estimated Hours to Replace</i>	<i>Hourly Rate</i>	<i>Materials</i>	<i>Direct Labor</i>	<i>Benefits, O/H Profit &amp; Opp. Costs</i>	<i>Total Costs</i>
Development	300	\$ 75.00	-	\$ 22,500	12,150	\$ 34,650
Project Management	2,000	\$ 50.00	-	\$ 100,000	54,000	154,000
Analyst	10,000	\$ 45.00	-	\$ 450,000	243,000	693,000
Programmer	15,000	\$ 45.00	\$ 2,500	\$ 675,000	365,850	1,043,350
Testing	1,000	\$ 30.00	-	\$ 30,000	16,200	46,200
Before-Tax Replacement Cost						1,971,200
Less Tax (@ 40%)						(788,480)
After-Tax Replacement Cost						\$ 1,182,720
Rounded						<u>\$ 1,183,000</u>

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – COST APPROACH

- **Despite limitations, the cost approach is the preferred method for valuing intangible assets that are readily replaceable, and when the cost of reconstructing or replacing the assets can be reasonably estimated**



## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – INCOME APPROACH

- **Based on economic principle of anticipation**
  - *Determine future economic benefits (generally cash flow)*
  - *Apply a discount rate for risk (determined using build-up or modified capital asset pricing model)*
  - *Divide future expected cash flow by discount rate, after reduction for growth, to produce indication of value*



## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – INCOME APPROACH

- **Applying approach to intangible assets (vs. business enterprise)**
  - *Includes discrete projection period due to finite expected life*
  - *Appropriate discount rate must be selected for the situation – consider inherent risk and whether the asset will be valued as part of a going concern or on stand-alone basis*
  - *Only future economic benefits associated with the subject asset can be considered (complex undertaking)*

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – INCOME APPROACH

- **Types of income considered to determine value of intangibles**
  - *Incremental (residual) income*
  - *Profit-split income*
  - *Royalty income*

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – INCOME APPROACH

- **First, analyst must determine three critical elements**
  - *Future economic benefits (cash flows)*
  - *Length of time associated with projected cash flows*
  - *Appropriate risk rate*



## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – INCOME APPROACH

- **Two methods to measure income under this approach**
  - *Yield capitalization method*
  - *Direct capitalization method*



## *Intangible Assets: Identification, Valuation & Issues*

### VALUATION METHODS – INCOME APPROACH

- **Incremental income analysis (“with and without” analysis)**
  - *Identify and quantify relevant economic criteria*
  - *Consider combined effects of increasing revenues and decreasing costs associated with subject intangible asset*
  - *Apply appropriate risk rate to the cash flows determined in the previous step*



## *Intangible Assets: Identification, Valuation & Issues*

### VALUATION METHODS – INCOME APPROACH

- **Incremental income analysis**
  - *Intended to look at benefits associated with the presence of the subject intangible asset (versus not having the asset)*
  - *Most often used to measure the value of noncompetition agreement*



## ***Intangible Assets: Identification, Valuation & Issues***

### INCREMENTAL INCOME METHOD EXAMPLE

- See calculation on page 33 of handout materials
- Determines value of intangible non-compete agreement by calculating the incremental value of AB Company “with” and “without” the agreement



## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – INCOME APPROACH

- Profit-split analysis
  - *Intended to derive a “fair economic return”*
  - *Based on “split” (allocation) of the total enterprise’s future economic benefits between subject asset and all other assets*
  - *Numerous facts and circumstances should be considered in determining the economic measure split*



## *Intangible Assets: Identification, Valuation & Issues*

### PROFIT-SPLIT METHOD EXAMPLE

Projected 2014 Net Sales	\$ 52,500,000
Projected 2014 Operating Profit Margin	10,500,000
Less: Taxes (@40%)	<u>(4,200,000)</u>
Projected Net Income	6,300,000
Less: Other Intangible Assets' Capital Charge	<u>(1,500,000)</u>
Projected Economic Income	4,800,000
Multiplied by: Profit-Split Percentage	<u>25%</u>
Indicated Profit-Split	1,200,000
Divided by: Capitalization Rate	<u>15%</u>
Value of Trade Name	<u>\$ 8,000,000</u>

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## *Intangible Assets: Identification, Valuation & Issues*

### VALUATION METHODS – INCOME APPROACH

- **Royalty income analysis**
  - *Used rarely, only in specific situations*
  - *Determination of hypothetical royalty rates presumed to be market-driven, thus often viewed as a market-based method*

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – MARKET APPROACH

- **Based on principle of competition – supply and demand**
- **Use data from open market transactions of comparable assets**
  - *Quality “guideline” information not always available*
  - *Lack of data can lead to misapplication of approach*
  - *Availability of information varies by type of asset*

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – MARKET APPROACH

- **Proper application of the approach**
  - *Based on research and analysis, develop valuation multiples (divide dependent economic variable by independent variable)*
  - *Apply these multiples to the same variables of the subject asset*
  - *Imperative to use guideline assets that are sufficiently similar to the subject asset – 9 basic elements of comparison*

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – MARKET APPROACH

- **Five primary methods under the market approach**
  - *Sales transaction method*
  - *Relief from royalty method*
  - *Comparative income differential method*
  - *Industry rules of thumb method*
  - *Market replacement cost method*

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – MARKET APPROACH

- **Sales transaction method**
  - *Estimates value based on actual market transactions*
  - *When data is available, considered the most direct and systematic approach to value estimation*

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – MARKET APPROACH

- **Relief from royalty method**
  - *Sometimes considered a method under the income approach or cost approach*
  - *Analyze actual arm's-length royalty or license agreements to determine a benchmark royalty rate*
  - *Multiply revenues expected to be generated by subject asset by the benchmark rate to estimate royalty stream*

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## ***Intangible Assets: Identification, Valuation & Issues***

### VALUATION METHODS – MARKET APPROACH

- **Applying the relief from royalty method**
  - *Assess terms of guideline license agreement(s)*
  - *Assess current status of industry, markets, trends*
  - *Estimate appropriate market-derived capitalization rate*
  - *Apply rate to appropriate economic income measure of the subject asset to determine value*

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## *Intangible Assets: Identification, Valuation & Issues*

### RELIEF FROM ROYALTY METHOD - GUIDELINE RATES

<i>Licensor</i>	<i>Licensee</i>	<i>Date</i>	<i>Terms</i>	<i>Royalty</i>	
				<i>Low</i>	<i>High</i>
GRT Name	A Company	Dec - 0X	Exclusive	2.0%	4.0%
BST Name	B Company	Sept - 0X	North America	0.5%	1.5%
No. One Name	C Company	June - 0X	Exclusive	1.0%	2.0%
Numero Uno	D Company	April - 0X	Exclusive	1.0%	3.0%
Chief Name	E Company	Dec - 0X	Exclusive	4.0%	4.0%
			High	4.0%	4.0%
			Low	0.5%	1.5%
			Mean	1.7%	2.9%
			Median	1.0%	3.0%
			Mode	1.0%	4.0%

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## *Intangible Assets: Identification, Valuation & Issues*

### RELIEF FROM ROYALTY METHOD CALCULATION

<i>In thousands (000)</i>	<i>2014</i>	<i>2015</i>	<i>2016</i>	<i>2017</i>	<i>2018</i>	<i>2019</i>	<i>2020</i>	<i>2021</i>
Revenue	\$105,000	\$115,500	\$133,000	\$148,000	\$161,000	\$170,000	\$178,000	\$187,000
Pre-Tax Royalty Rate	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Pre-Tax Royalty Savings	2,100	2,310	2,660	2,960	3,220	3,400	3,560	3,740
Less: Taxes	(840)	(924)	(1,064)	(1,184)	(1,288)	(1,360)	(1,424)	(1,496)
After-Tax Royalty Savings	\$ 1,260	\$ 1,386	\$ 1,596	\$ 1,776	\$ 1,932	\$ 2,040	\$ 2,136	\$ 2,244
Present Value Factor	0.9054	0.7421	0.6083	0.4986	0.4087	0.3350	0.2746	0.2251
Present Value of After-Tax Royalty Savings	\$ 1,141	\$ 1,029	\$ 971	\$ 885	\$ 790	\$ 683	\$ 586	\$ 505
Sum of Royalty Savings		\$ 6,590,051						
Rounded		\$ 6,600,000						

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## *Intangible Assets: Identification, Valuation & Issues*

### RELIEF FROM ROYALTY METHOD CALCULATION

- **Sum of royalty savings \$ 6,590,051**
- **Rounded \$ 6,600,000**
- **Fair market value of subject trade name is \$6.6 million**

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## *Intangible Assets: Identification, Valuation & Issues*

### VALUATION METHODS – MARKET APPROACH

- **Comparative income differential method**
  - *If information is available, income generated by two similar operations (with subject asset and without) can be compared*
  - *Differential in company performance can be associated with the intangible asset and capitalized to determine its value*
  - *May be applicable to franchise agreements, proprietary technology, trade names, patents, etc.*

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## *Intangible Assets: Identification, Valuation & Issues*

### VALUATION METHODS – MARKET APPROACH

- **Rules of thumb**

- *Should be considered in some cases, but rarely (if ever) should be used as primary source of valuation*
- *Quite simplistic and often obscure important details*
- *“Prices” generated are often not cash-equivalent values*

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## *Intangible Assets: Identification, Valuation & Issues*

### VALUATION METHODS – MARKET APPROACH

- **Market replacement cost method**

- *Contemplates replacement cost of asset in the open market*
- *Uses owner’s records as well as information from knowledgeable outsiders*
- *Limited use, as accurate replacement costs difficult to identify*
- *Most often considered under the cost approach due to the procedures used to determine replacement cost*

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## *Intangible Assets: Identification, Valuation & Controversial Issues*

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### COURT CASES ADDRESSING INTANGIBLE ASSET VALUATION

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## *Intangible Assets: Identification, Valuation & Issues*

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### RELEVANT COURT CASES

- **Langdon v. Commissioner**
  - *Bemidji Distributing Company, Inc. (BDC), a wholesale beer distributor sold to Bravo Beverage, Ltd.*
  - *No purchase price value allocated to intangible assets (customer list, brand name, distribution rights)*
  - *IRS challenged the allocation and assessed a deficiency*
  - *Tax Court used 9-factor test, and held in favor of the IRS, which was affirmed on appeal*

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## *Intangible Assets: Identification, Valuation & Issues*

### RELEVANT COURT CASES

▪ **Bobrow v. Bobrow**

- *Husband's partnership interest in Ernst & Young subject to valuation in marital dissolution case*
  - Interest in consulting division, as well as in firm as a whole
- *Husband's expert did not include value of enterprise goodwill*
- *Wife's expert performed several analyses to determine value*
- *Court accepted testimony of wife's expert*

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## *Intangible Assets: Identification, Valuation & Issues*

### RELEVANT COURT CASES

▪ **Kenner v. Kenner**

- *Valuation of toy company in marital dissolution*
- *Wife's expert did not include value for intangible assets*
- *Husband's expert's valuation accepted by court – value of intangibles (name brands) = \$5 million*

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## *Intangible Assets: Identification, Valuation & Issues*

### RELEVANT COURT CASES

- **Carnegie Mellon University v. Marvell Technology Group, Ltd.**
  - *CMU claimed Marvell infringed on patents related to hard drive control chips*
  - *CMU’s expert performed a “Georgia-Pacific” analysis and determined a reasonable royalty rate of 50¢ per chip*
  - *Marvell’s expert proposed lump sum payment, not to exceed \$250,000 billion*

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## *Intangible Assets: Identification, Valuation & Issues*

### RELEVANT COURT CASES

- **Carnegie Mellon University v. Marvell Technology Group, Ltd.**
  - *Court ruled in favor of CMU, awarding \$1.17 billion (largest patent verdict in history) for willful infringement – represented 50¢ per chip sold (2.2 billion since 2003)*
  - *Marvell filed a post-trial motion, accepting the royalty rate but asking limiting damages to chips produced in the U.S.*
  - *U.S. District Court ordered Marvell to pay CMU \$1.54 billion in damages – includes \$1.1 billion from original verdict, as well as punitive damages for willful infringement*

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## *Intangible Assets: Identification, Valuation & Issues*

### RELEVANT COURT CASES

- **Bowman v. Monsanto Co.**
  - *Monsanto sued farmer Bowman for patent infringement for unauthorized use of Roundup Ready® soybean seeds*
  - *Bowman's patent exhaustion argument was rejected by Court*
  - *Independent expert determined damages which were less than the cost for Bowman to legally buy and plant seeds*
  - *Monsanto contested, but Court used amount for calculation*

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## *Intangible Assets: Identification, Valuation & Issues*

### RELEVANT COURT CASES

- **Valuators must have knowledge of methodologies and the experience in valuing intangible assets to make decisions requiring professional judgment**

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CONCLUSION AND  
PRACTICAL CONSIDERATIONS

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CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Future business growth driven by intangible assets**
- **Understanding value is key to client service, and cooperation between attorneys and accountants/valuators is important**
- **GYF can assist attorneys and their clients in this area**

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