AICPA Issues Valuation Practice Standards

By Brent K. Bersin

Abstract

With the continuing transition of the U.S. from a manufacturing to a service economy, intangible assets comprise an increasingly significant portion of corporate market values and balance sheets. Consequently, the valuation of intangible assets constitutes a considerable issue to LES members, and their employers and clients. The American Institute of Certified Public Accountants ("AICPA") recently released its first valuation practice standards for its CPA members, an overview of which is provided in this paper.

Introduction

In June 2007, the Consulting Services Executive Committee of the AICPA announced the release of its first practice standards for valuation services provided by its members, *Statement on Standards for Valuation Services No. 1, "Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset,"* (referred to herein as the "Statement"). The Statement provides authoritative practice guidance to CPAs for preparing estimates of value and reporting the results, and is effective for engagements accepted on or after January 1, 2008 (with earlier adoption encouraged). The Statement was developed with input of 11 constituency groups within the AICPA, in addition to many of the largest accounting firms, The National Association of Certified Valuation Analysts, and Duff & Phelps, among others.

The AICPA developed the Statement to promote consistency of practice among its members, who are increasingly performing valuation engagements. According to Barry Melancon, AICPA President and CEO, "Congress, government agencies and accounting regulators have recently focused their attention on appraisal issues—such activity shows the importance of valuation to the business community and individuals. In addition, an increasing number of CPAs offer valuation services. [The Statement] promotes greater transparency and provides our members with a set of guidelines in the unique context of a CPA practice."[1]

While the Statement encompasses the many classes of business assets, this paper examines the Statement as pertains to the valuation of intangible assets.

Intangible Asset Valuation

While there are numerous legal, accounting, or taxation-related definitions of "intangible asset," the Statement defines intangible assets as *"non-physical assets such as franchises, trademarks, patents, copyrights, equities, mineral rights, securities, and contracts that grants rights and privileges and have value for the owner."*

CPAs perform valuations of intangible assets for a variety of purposes including litigation support, taxation, purchase price allocations, technology transfer, mergers and acquisitions, among others. Intangible asset valuation services are also being provided within a variety of professional settings such as consulting firms, accounting firms, and investment firms. A number of factors are driving the need for intangible asset valuations: 1) the increasing portion of company value comprised by intangible assets, 2) purchase price allocations and annual goodwill impairment testing required by FAS 141 and 142,[2] and 3) stakeholder interest in the value of intangible assets, among other things.

In September 2006, the Financial Accounting Standards Board ("FASB") also issued FAS 157 (effective for fiscal years beginning after November 15, 2007) which moves forward valuation by defining the term "fair value," establishing a framework for measuring fair value in accordance with generally accepted accounting principles ("GAAP"), and expanding disclosures about fair value measurements (concerning intangible assets and other business assets).[3]

Expected Benefits of the Statement

As noted above, the intention of the Statement is to provide authoritative guidance to member CPAs in order to promote consistency and quality of service among valuation practitioners and practices. More specifically, the identified goals of the

1. "AICPA Issues Statement on Standards for Valuation Services No. 1," AICPA Press Release, June 21, 2007.

2. For more information, please reference FAS 141, *"Business Combinations"* and FAS 142, *"Goodwill and Other Intangible Assets,"* both of which issued in June 2001.

3. For more information please reference FAS 157, *"Fair Value Measurement."* Also see: Chris Bakewell and Bryan Benoit, *"A Step Forward for the Valuation Community," les Nouvelles*, June 2007.

Statement include:

- Providing members with professional guidance in the area of valuation
- Promoting best practices for valuation services
- Enhancing the transparency and reliability of valuation analyses and valuation reports
- Encouraging greater standardization of valuation report content and format
- Enhancing the reliance on the valuation process by various stakeholders and parties-in-interest.
- Setting of clear expectations among members and their clients with pre-defined levels of valuation services and types of valuation reports
- Providing a benchmark for compliance with the Pension Protection Act of 2006 "generally accepted appraisal standards" provisions when members provide certain tax-related valuation services

Intangible Asset Valuation and the Statement

In this paper, the Statement's content, as it relates to the valuation of intangible assets, is examined in the context of four major categories listed below.

1) Engagement Considerations
2) Type of Engagements
3) Valuation Approaches and Methods
4) Valuation Reports

Engagement Considerations

The Statement refers to a CPA who performs valuation engagements as a "valuation analyst." As with all professional services rendered by CPAs, the valuation analyst is required to comply with standards of professional competence (set forth in Rule 201A of the AICPA Code of Professional Conduct). To wit, a valuation analyst should possess a level of knowledge of valuation principles and theory, and a level of skill in the application of such principles, that will enable them to identify, gather, and analyze data, consider and apply appropriate valuation approaches and methods, and use professional judgment. Professional competence should necessarily include experience with, and professional competence in, the valuation of intangible assets which differ in important ways from other types of business assets.

Prior to undertaking a valuation assignment, the valuation analyst should form an understanding with the client, preferably in writing, in order to establish clear expectations. At a minimum, the understanding with the client should include the nature, purpose, and objective of the valuation, the client's and the valuation analyst's respective responsibilities, applicable assumptions and limiting conditions, the type of report to be issued, and the standard and premise of value.

Types of Engagements

Two types of engagements are identified by the Statement: 1) valuation engagements and 2) calculation engagements.

Valuation Engagement. Of the two engagement types, the valuation engagement is more comprehensive and detailed, in terms of information considered, approaches and procedures employed, and associated documentation. To perform a valuation engagement, the Statement indicates that the valuation analyst should consider: 1) the subject interest, 2) non-financial information, 3) ownership information, and 4) financial information, as described in more detail below.

■ Brent K. Bersin, Director in the Intellectual Property practice of Navigant Consulting, Inc. ("Navigant"), Houston TX, U.S.A.
E-mail: brent.bersin@navigantconsulting.com

The Subject Interest

- Nature of the subject interest
- Scope of the valuation engagement
- Valuation date
- Intended use of the valuation
- Applicable standard of value
- Applicable premise of value
- Assumptions and limiting conditions
- Applicable governmental or other professional standards

Non-Financial Information

- Products and/or services facilitated by the intangible assets
- Management team
- Economic environment
- Industry
- Key customers
- Competition
- Other

Ownership Information

- Determine the type of ownership being valued
- Analyze the different ownership interests of other owners and the potential impact on value
- Understand the classes of equity ownership and the rights attached thereto
- Understand the rights included in, or excluded from, each intangible asset
- Understand other matters that may impact the value of the subject interest such as: legal rights, licensing agreements, sublicense agreements, nondisclosure agreements, development rights, commercialization or exploitation rights, and other contractual obligations

Financial Information

- Historical financial information (annual and quarterly financials, etc.)
- Prospective financial information (budgets, forecast, etc.)
- Comparative summaries of financial statements
- Income tax returns
- Other

The valuation analyst may consider and apply the income, market, and cost approaches (and related methods) in order to arrive at a result referred to as a *conclusion of value*. A conclusion of value may be expressed as either a single amount or range of values, after the results under the various approaches have been reconciled and duly assessed for reliability. The Statement further describes the type of documentation that the valuation analyst should retain to support the conclusion of value, which is listed below. Such documentation should be retained for a period of time sufficient to meet applicable legal, regulatory, or other professional requirements.

- Information gathered and analyzed
- Assumptions and limiting conditions
- Any restriction or limitation on the scope of the valuation work
- Basis for use of any valuation assumptions
- Valuation approaches and methods considered and used
- Information related to any subsequent events considered
- Support for the use of any "rule of thumb"
- Other documentation

Calculation Engagement. A calculation engagement is more limited in scope than a valuation engagement, with the procedures and methods to be employed agreed upon with the client prior to beginning the assignment. The results of a calculation engagement are referred to as a calculated value, which may be expressed as either a single value or range of values. Items that should be considered by the valuation analyst for a calculation engagement include at least the following:

- Identity of the client
- Identity of the subject interest
- Control or marketability issues
- Purpose and intended use for the calculated value
- Intended users of the report and limitations on its use
- Valuation date
- Applicable standard of value
- Applicable premise of value
- Sources of information used
- Valuation approaches or methods agreed upon with the client
- Subsequent events, if applicable

Valuation Approaches and Methods

According to the Statement, the valuation analyst should use and consider three accepted approaches to value an intangible asset: 1) income approach, 2) market approach, and 3) cost approach, which are described below.

Income Approach. This approach is defined by the Statement as a general way of describing a value indication for an intangible asset using one or more methods that convert anticipated economic benefit into a present-value, single amount. The two most common income approach methods are: 1) *capitalization of benefits method* and 2) *discounted future benefits method*. Moreover, the Statement specifies that the following factors should be considered when performing the valuation of an intangible asset (in addition to considerations for estimating the value for other business assets, as described in the Statement):

- Remaining useful life of the intangible asset
- Current and anticipated future use of the intangible asset

- Rights attributable to the intangible assets
- Position of intangible asset in its life cycle
- Appropriate discount rate for the intangible asset
- Appropriate capital or contributory asset charge, if any
- Research and development or marketing expense needed to support the intangible asset in its existing state
- Allocation of income to intangible asset
- Whether any tax amortization benefit should be included in the analysis
- Discounted multi-year excess earnings
- Market royalties
- Relief from royalty

Market Approach. This approach is defined by the Statement as a general way of determining a value indication for an intangible asset by using one or more methods that compare the subject intangible asset to similar intangible assets which have been sold (also transferred or licensed with respect to intangible assets). There are three frequently used market approach methods to value an intangible asset:

- **Comparable uncontrolled transactions method**. Based on arm's-length sales or licenses of the guideline intangible assets.
- **Comparable profit margin method.** Based on comparison of the profit margin earned by the subject entity that owns or operates the intangible asset to profit margins earned by guideline company intangible assets.
- **Relief from Royalty Method.** Based on a royalty rate, often expressed as a percentage of revenue that subject entity owns or operates the intangible asset would be obligate to pay a hypothetical third-party licensor for use of that intangible asset.

Cost Approach. This approach is defined by the Statement as a general way of determining a value indication for an intangible asset by the amount of money required to replace future service capability of the asset. When using the cost approach to value intangible assets, the valuation analyst should consider the type of cost to be used (for example, reproduction cost or replacement cost).

Types of Valuation Reports

A valuation report is a written or oral communication to the client containing the conclusion of value or the calculated value of the subject intangible asset. Reports issued for purposes of certain controversy proceedings (such as an arbitration matter or matter before a Court) are exempt from this reporting standard. For a valuation engagement, resulting in a conclusion of value, there are two types of written reports which may be used:

- **Detailed Report.** A detailed report is structured to provide sufficient information to permit intended users to understand the data, reasoning, and analyses underlying the conclusion of value. The disclosures and content required of this type of report are described more fully in the Statement.
- **Summary Report.** A summary report is structured to provide an abridged version of the information that would be provided in the detailed report, and does not require the same level of detail and disclosures as a detailed report. The minimum requirements for a summary report are described more fully in the Statement.

For a calculation engagement which results in a calculated value, only one type of written report is specified; a **calculation report**. The report should state it is a calculation report, include a number of disclosures (described more fully in the Statement), reflect the calculated value, and identify the following:

- Any hypothetical condition used and basis for their use
- Any application of the jurisdictional exception
- Any assumptions and limiting conditions
- Reliance on any specialist's work
- Disclosure of any subsequent events

Exceptions to Applicability of the Statement

There are some exceptions to required application of the Statement. Exceptions to applicability include the following:

- Estimating the value of a subject interest as part of performing an attest engagement
- The value of a subject interest is provided by the member by the client or a third party, and the member does not apply valuation approaches and methods as discussed in the Statement
- Internal use assignments from employers to employee members which are not in the practice of public accounting
- Engagements exclusive for the purposes of determining economic damages (for

example, lost profits) unless those determinations include an engagement to estimate value

- Mechanical computations that do not rise to the level of an engagement to estimate value; that is when the member does not apply valuation approaches and methods and does not use professional judgment
- Situations whereby the member cannot reasonably obtain or use relevant information and, as a result, cannot apply accepted valuation approaches and methods
- A jurisdictional exception, whereby the Statement differs from published governmental, judicial, or accounting authority

Conclusion

Clearly, the Statement is timely given the increased need for reliable and independent valuations and reporting of intangible assets. The resulting implementation of the Statement should be a win-win for both CPAs and their clients alike, as valuation practice standards are made more consistent across firms and practices. Moreover, the Statement's authoritative guidance and standards, and implementation of such by CPAs, renders the resulting valuation work inherently more reliable and withstanding of scrutiny. ■