

## Software & Valuation In The Information Society

By Dwight Olson

The LES mantra of the 1990s was that “Wealth in the 21st Century would be measured in ownership of intellectual property.” Well, the information age is here and we see an increasing number of corporations accumulating wealth based on intellectual property including (Software). We watched Microsoft’s enterprise value pass one quarter of a trillion dollars and annual revenue exceed fifty billion dollars, with much of it due to Software licensing. Yet, we see few line items on their corporate financials touting ownership of intellectual property including Software assets. One is left with the thought, “where’s the beef?”

Software comes in various forms; it can be as simple as a process for a color scheme covering a package, a client/prospect list, or a massively scalable online financial system. Software can be as complex as a million lines of source code for a computer operating system, or it can be as subtle as the process sequence of certain manufacturing steps. Software often makes a huge difference between success and failure for a corporation.

In the evolving intellectual property asset infrastructure, accurately identifying, analyzing, and evaluating Software by and within an enterprise, continue to be important, and ever more critical is valuation as the government regulations such as Sarbanes-Oxley and Federal Accounting Standards Board (FASB) 141/142 force effective valuation and careful governance of intellectual property including Software. There will be more! Probes for transparency to understand a corporation’s intellectual property assets and how they are used, are changing both the governance of Software assets and their financial importance. Governments want to be able to tax appropriately, stockholders want management to maximize value, and the financial world wants to have a more knowable investment in a digital company and its future.

Whether working in bankruptcy or reorganization, on a FASB 142 Purchase Price Allocation (PPA) assignment for merger or acquisition, we see a broad range of intellectual assets in the form of intellectual property and intangibles. There are three key questions for Software: Which of these Software assets have value? Which of these Software assets could be monetized? And, third, how much might an institution lend on the Software as collateral?

How does the value of Software affect a merger whether it is licensed or just used? It can have a substantial impact. The new FASB 141/142 Rule has a major impact on the importance of intangible assets. The purchase price allocation calls on a valuation house to identify all intangible assets including Software with definable lives, to then value those assets with definable lives, and to then depreciate these assets over the remaining useful life estimated by the valuator.

### Corporate Governance And Transparency For FASB

Purchase price allocation is the process of assigning fair values to all major assets and liabilities of an acquired enterprise following a business acquisition or merger. For federal tax purposes, when intangible assets are acquired in the purchase of a trade or business, the purchase price must be allocated to the underlying assets for purposes of determining depreciation and amortization allowance under Internal Revenue Codes IRC §167 and §197. The actual allocation is governed by IRC §1060(a) and Reg. §1.1060-1, which require a buyer and seller of a business to allocate the purchase price according to the rules of IRC §338(b) (5) and Reg. §338-6. Under this method, the buyer and the seller must use the residual method to allocate the purchase price.

Purchase price allocation for financial accounting purposes has recently undergone significant and complex changes. Accounting Principles Board (APB) Opinion 16 and APB 17 have been superseded by FASB No. 141, Accounting for Business Combinations, and FASB 142, Accounting for Goodwill and Other Intangibles. Under FASB 141 all business combinations must now be accounted for using the purchase method, based on the values of the Software exchanged. Under FASB 142, goodwill and indefinite-lived intangibles are no longer amortized. Additionally, Goodwill and Software must now be tested annually for asset impairment at the reporting unit level and on an interim basis if an adverse triggering event takes place. Corporations that are planning a business merger should consider the effect of the transaction under the new rules and plan to carry out a thorough purchase price allocation accordingly. In addition, International Accounting Standards (IASB) have been issued that parallel FASB for financial reporting, consequently, there is a need for experience and expertise to accurately navigate

the myriad of valuation issues encountered in a complex Software purchase price allocation. There is a need for professionalism and corporate financial governance at its cornerstone.

## Corporate Governance And Transparency In Sarbanes-Oxley

Properly managing Software assets has never been more important to a corporation's well-being. Granted, the dangers of patent infringement, license violations and counterfeiting have always been a threat to a Software owner's profit margin and taking media headlines. With regulators' increased emphasis on transparency and reporting of all material risks to shareholder value, the ability to appraise and keep track of Software can mean the difference between weathering a conflict with regulators and having regulatory investigations with a shareholder class action suit piled onto it.

Software—whose asset component protections range from patent, copyright and trade secrets, to unprotected market ideas and undocumented process know how—can account for as much as 80 percent of a company's total market value. Threats to Software assets therefore create a very real concern for shareholders.

As a result of Sarbanes-Oxley, Software financial governance is now the corporate executives' responsibility, categorizing the company's Software asset portfolio, assess the value of each and monitor its use by the company as well as its licensees and even its competitors. Executives are also obligated to foster a culture of compliance and are subject to criminal and civil penalties under the Economic Espionage Act of 1996 for allowing for the misappropriation of third-party trade secrets. Failure to abide by these regulations also could result in inaccurate financial statements which can in turn cause very serious problems for the company.

Responsibility for a company's Software assets generally falls under the umbrella of the legal department. Unfortunately, many companies have assigned this task to a person or small department, unequipped for this task, not adequately recognizing the potential consequences. By understaffing or improperly controlling a company's Software asset portfolio, organizations can both cut into their profit margin and put the company in jeopardy of a shareholder dispute or regulatory inquiry. So where do we start in Software financial governance?

## FASB 86 For Software Analysis And Valuation

FASB 86 was undertaken in response to requests by

the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA) to record certain costs as a Software asset. FASB 86 establishes standards of financial accounting and reporting for the costs of computer Software to be sold, leased, used, or otherwise marketed; whether internally developed and produced or purchased. Software as an asset is best understood within the framework leading to acceptance of FASB 86, where research for this Statement included technology feasibility, management commitment, financial feasibility, ownership statements, and intellectual property rights (such as treating source code as trade secrets and appropriate use of patents), or quality factors, leading to Software commercial ability. A proper analysis of the components and their valuation in light of commercial ability provides for financial governance of Software that can be used in establishing and maintaining asset value.

Identification of components, rights and other proprietary assets that make current value and future use is critical. For example, as stated in FASB 141/142 a component value for a Software asset must be established in a Merger or Acquisition. The allocation of that value must be done with consideration to future potential. After an acquisition, access to the source code of that Software is mandatory or critical to the ability to maintain the value of that Software acquisition. One could consider the FASB 86 requirements the de facto standard for establishing quality of Software for monetization.

## Software Has Value But What Valuation Method?

Often time's regulations may govern the best method for determining the appropriate value but they often times also admit the possibility of using other, unspecified, methods. For example, the selection of the appropriate transfer pricing valuation method relies on the "best method" rule; Comparable Uncontrolled Transaction Method (CUT), Comparable Profit Margin Method (CPM), or Profit-Split Methods (PSM) and admits the use of unspecified methods, such as replacement costs. But whichever method is selected for this particular transfer purpose, all methods determine a value which should be commensurate with the Software and its future ability for monetizing (licensing and other revenue).

Determining the actual worth of a Software asset can be difficult. Valuation methods for Software as-

■ Dwight Olson, V3Data,  
Principal, San Diego, CA, USA  
E-mail: [dcolson@ix.netcom.com](mailto:dcolson@ix.netcom.com)

sets are not as developed as valuation methods for tangible assets. Many valuation experts disagree on which method is best for valuing different types of Software. Current methods for valuation of Software generally fall within one of the three categories: the Cost Approach for valuing Software based on how much it actually costs to create or recreate that asset, the Income (Net Present Value) approach for valuing Software based on all revenue (licensing, support, and maintenance), and the Market approach for valuing Software based on the licensing, patent royalty rates (if included in the Software product), or sales of similar Software products from one company to another. Experts say that while you may use any one of the three approaches to reliably estimate Software value, it is best to compare the results obtained by using two approaches to sufficiently challenge the results and determine a likely range of value for the Software.

At issue in FASB 86 was commercial applicability for a computer Software product, or a product enhancement. The Statement identifies the costs to be expensed, costs to be capitalized, and it specifies amortization, disclosure, and other requirements. But from corporate financial governance is it not all costs involved in developing all components of a Software product required to bring a Software product to market the true “ownership” value of the Software asset? Software product analysis and valuation should deal with the sum total (or bundle) of the IP component values that will make a Software product commercial or useful. A simple formula to establish

ownership value using FASB 86 quality factors was developed by Data Securities International (DSI), a Software escrow company, for Software product valuations requested by many companies for the purposes of: establishing shareholder equity, debt financing, merger and acquisitions, or a fair market value for a Software product prior to market launch.

The basic formula developed by Data Securities International was Total Software Product Value (TSPV) equals the sum of Ownership Value (OV) multiplied by the Composite of Influencing Factors (CIF) plus Market Value (MV) plus Internal Cost Savings (ISC). This formula provided for Software developed for commercial use to be valued for a variety of purposes. As you would expect, the quality influencing factors were technology feasibility, management commitment, financial feasibility, ownership statements, and intellectual property rights. If these factors were less than one (1), they would weigh heavily on the Ownership Value. For a Software product manager really makes sense.

FASB 86 does not specifically call out intellectual property rights as a requirement, but if you don't have the work for hire agreement or copyright assignment for the Software product components, you really don't own the property rights to do anything with the Software to extract additional value.

Financial governance of Software should take into account the quality factors discussed in FASB 86, and are still in practice today, for companies that want to amortize portions of the costs of the Software they purchased or plan to license in the marketplace. ■