

## **How to Value and Protect A Company's Goodwill and Its Intangible Assets**

- **23 Intangible Assets to Identify**
- **How to Protect Them**
- ***Case Study: 5 Ways to Value Intangibles***
- ***Case Study: How to Value Goodwill***
- **How the IRS Values Goodwill**
- **How to Protect Intellectual Property**
- **Goodwill and the Tax Law**
- **Goodwill and Sale of Business**

## Why This Report Is Important

This discussion of a company's goodwill and intangible assets is divided into four parts.

Section #1 deals with goodwill in general, lists the components of goodwill by category, and explains the net tangible assets/capitalized income method of valuing goodwill. A case study illustrates the concepts.

Section #2 shows how to use five methods to identify and value intangible assets which usually are not recorded or shown on a company's balance sheet. These intangible assets include patents, customer lists, start-up costs, special manufacturing processes, exclusive territory rights, etc. There are examples to help you better understand how to mathematically value these assets.

Section #3 discusses how to protect your company's intangible assets from misuse and theft by your employees, competitors, and independent contractors. There also is information on patents, trademarks, and trade secrets.

Section #4 explains the tax treatment of goodwill, intangible assets, consulting and employment contracts, and noncompete agreements, when selling or buying a business. It also presents many strategies designed to help you obtain more after-tax money on your intangible assets when selling or buying a business.

\* \* \*

*Applications:* Although we refer to shares in a corporation in the examples and case studies, the concepts apply to *all* forms of business and ownership positions, including partnerships, sole proprietorships, C and S corporations, joint ventures, affiliated companies, and limited liability companies.

*Size:* If your company is larger or smaller than those cited in the case studies, don't worry about it. Again, it's the analysis and examples that are important.

*Definitions:* Net tangible assets is total tangible assets *less* all liabilities. It

is the same as a company's net worth, net book value, or stockholder's equity account. The use of the term "tangible" assets means you subtract from total assets any *intangible* assets, such as a company's start-up costs, research and development expenditures, and deferred financing costs where the cash has already been expended, but the amounts were capitalized on the balance sheet to be written off over future years.

If you have any questions or comments on this Report, please call, e-mail, or write to us.

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# *Section #1*

## **How to Value Goodwill And Intangible Assets**

- **What Are the Components of Goodwill?**
- **How Do You Identify Intangible Assets?**
- **How Does the IRS Value Goodwill?**
- ***Exhibit 1: Going-Concern Valuation Methods***
- ***Exhibit 2: IRS Revenue Ruling 59-60***

***Case Study: Smith International, Inc.***

**Every business, by the simple fact that it is established and operating, has goodwill attached to it.**

## **One Approach to Valuing Goodwill**

### **Net Tangible Assets and Capitalized Income Method**

- #1.** Compute the company's average net book value and its average net income for the last three to five years. (You use average net book value and net income since goodwill is built up over time.)
- #2.** Determine your industry's average percent return on net book value.
- #3.** Multiply your industry's percentage return by your company's average net book value.
- #4.** Subtract your company's average net income by the result in #3.
- #5.** The difference in #4, the *excess* net income, is then capitalized at a 10% to 20% rate of return; we used 15% in this section.

The value of goodwill can represent a good portion of any business' final value. But establishing a dollar value for that goodwill is never a clear-cut task. Still, you have to translate goodwill into hard numbers as part of any selling price or offer to buy a business.

With the explanations offered in this Report, you can demonstrate to the seller or buyer of any business that you didn't pull a goodwill value out of thin air, that the figure you have arrived at has a basis *in fact*.

## **What Is Goodwill?**

Goodwill is principally the *intangible assets* of a business, such as an established customer base, marketing know-how, or arrangements with suppliers or creditors that have been negotiated and are in place. It includes patents, trademarks, customer lists, reputation, history — elements that contribute to the success and worth of a business but may not be recorded or even reflected in a company's financial statements. Although these intangible assets may have no dollar value on the balance sheet, they do have an operating value and therefore must be included when calculating a *total* value for a business.

Because it is intangible, goodwill is hard to define without resorting to specific assets and examples. In judicial disputes, many courts have used the following language to define goodwill:

*"Goodwill is the advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or from celebrity or reputation for skill or affluence or punctuality, or from other accidental circumstances or necessities or even from ancient partialities or prejudices."*

In other words, goodwill is comprised of those components of a business that convince customers to remain as customers and that, as a result, allow the business to generate a profit or a rate of return on investment that exceeds the return that might be expected solely from the assets that the company has for its use. For example, *A&D Medical Company*, a successful drug company, earns high profits and has a high rate of return on its assets and stockholders' equity — higher than many other companies that have the same level of assets and net worth. These "excess

earnings" come partially from the goodwill that A&D has generated. This goodwill can be further defined in A&D's case, for example, as the high level of research it has developed, its established customer base, and its consistent ability to increase revenues and overall profitability.

For many companies, goodwill also has been simply defined as the value that is at least equal to *the total capital a new business would require to get where an established business is today*. This obviously includes many intangible assets, as well as the replacement value of the company's tangible assets, such as equipment, cars, real estate, inventory, and accounts receivable.

## **Elements of Goodwill**

A company's intangible assets generally can be divided into three categories:

1. Intangible assets that *cannot* be separated from the business.
2. Intangible assets that *cannot* be separated from management, employees, or owners.
3. Intangible assets that *can* be separated from the business.

Let's take a closer look at these three categories.

### ***Category #1:***

#### **Intangible assets that *cannot* be separated from the business**

*The following would be included in this category:*

- Any start-up costs that the company already has funded.
- Trained employees.
- Advantages accruing to the company's physical location.
- Promotion and advertising efforts already undertaken.
- Production and operating facilities.
- The reputation that the company has established.
- The customer base.
- Accounting systems and controls that are already in place and functioning.

### ***Category #2:***

**Intangible assets that *cannot* be separated from management, employees, or owners**

*The following would be included in this category:*

- The general skills of employees in such areas as overall management ability, customer relations, administration, and employee relations.
- The reputation of the company's owners, managers, and employees in running the business.
- How the company got to *where it is today* and *where it's going*.

### ***Category #3:***

**Intangible assets that *can* be separated from the business**

*In this third category, the following would be included:*

- Leasehold interests
- Trade names
- Trademarks
- Copyrights
- Patents
- Licenses
- Franchises
- Secret methods and formulas
- Drawings and dies
- Mailing and customer lists
- Contracts, including purchase, sales, and employment contracts
- Manufacturing processes.

All of these "goodwill" assets contribute to the success of the business and therefore to its value. But they are intangible and don't, in many cases, show up on the company's financial statements. *So, how can they be valued?*

## **Valuation of Goodwill**

A number of methods can be used to value goodwill. They can be separated broadly into two principal categories: (a) net tangible assets/capitalized income method and (b) five other methods, which are explained in the next section.

## **Net Tangible Assets/Capitalized Income Method**

This method for valuing goodwill is one of the most important because, if a dispute arises with the government over the valuation of goodwill, this is one of the methods on which the IRS often relies.

It also is important to understand because the value derived is based on the concept that *the existence of goodwill creates an excess rate of return in a business*. Thus, this method is designed first to isolate that excess return and then to put a value on it. It is computed as follows; there are five steps:

1. The value of the company's net tangible assets (net book value less intangible assets) and its net income are averaged for the last three to five years. (Average net book values and earnings are used since goodwill is built up over time.)
2. You then determine what industry the company is in and that industry's average return on net book value (say, 10%).
3. You multiply the industry's 10% return by the company's average net book value (tangible assets less liabilities).
4. To determine the company's *excess* earnings, the result of Step 3 is deducted from the company's *actual* average net income.
5. The result in Step 4 is then capitalized, normally at a 10% to 20% capitalization rate. For our example, we use a capitalization rate of 15%.

*Valuation comment:* If a company's profits are nominal, goodwill can still be valued by identifying and writing up select intangible assets to fair market value. For example, it may have cost you \$50,000 to develop a nationwide mailing list, which has been fully written off for tax purposes. This value can be added to the net book value of the business. How you do that is explained in Section #2. For now, we will use a case study on how to value goodwill using the five steps above.

### ***Case Study: Smith International, Inc.***

Let's assume the following financial data for *Smith International, Inc.*, a manufacturer of electronic relay components. (The averages are based on the

company's financial statements for the last three years.)

Average Total Assets	\$1,500,000
<i>Less:</i> Average Intangible Assets	100,000 <sup>(1)</sup>
<i>Less:</i> Average Liabilities	<u>600,000</u>
Tangible Net Book Value	<u>\$ 800,000</u> <sup>(2)</sup>
Average Net Income	\$ 140,000
Industry Return on Net Book Value	10%
Goodwill Capitalization Rate	15%

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(1) Includes items such as deferred financing and product development costs which were capitalized on the balance sheet solely to be written off over the term of the financing or the life of the product.

(2) Tangible net book value is the same as a company's tangible stockholder's equity or tangible net worth, i.e., the equity account less intangible assets.

Using the facts for *Smith International*, the value of its goodwill is calculated as follows:

**Step 1:** Company's average tangible net book value  
= \$1,500,000 *minus* \$600,000 liabilities *minus* \$100,000 intangible assets  
= \$800,000 tangible net book value

**Step 2:** Determine industry's return on net book value  
= 10%

**Step 3:** Company's average net book value times industry's return on net book value  
= \$800,000 *times* 10%  
= \$80,000

**Step 4:** Company's average net income of \$140,000 less industry's return on net book value  
 = \$140,000 *minus* \$80,000  
 = \$60,000 excess net income

**Step 5:** Excess net income *divided by* the capitalization rate of 15%  
 = \$60,000 *divided by* 15% (0.15)  
 = **\$400,000 value of goodwill**

**Total value.** Using this method, the value of *Smith International's* goodwill is \$400,000. This \$400,000 value is then added to the company's tangible net book value of \$800,000 to arrive at the company's total value.

Value of Tangible Net Book Value	\$ 800,000
Value of Goodwill	<u>400,000</u>
Total Value of Company	<u><u>\$1,200,000</u></u>

Goodwill has a high value in this company; it represents 33% of the total \$1.2 million value. While its industry is earning a return of only 10% on tangible net book value, *Smith International* is earning 17.5% (\$140,000 average earnings divided by \$800,000 tangible net book value). Therefore, this superior performance must be due to the company's intangible components — perhaps its strong customer base, sophisticated technology, or superior management.

### **Comparison to Current Income and Net Book Value**

The total value of the company (including its goodwill as calculated by this method) should be compared with the values arrived at by using other valuation methods. For example, let's assume that *Smith International's* actual net income for last year was \$120,000, not the \$140,000 *average* we used in our case study. This means that the company's total value of \$1,200,000 (as calculated by the tangible assets/capitalized income method above) would be equivalent to 10 times earnings — a price-earnings multiple (p/e) of 10. Now, a 10 multiple may be low when compared to other smaller companies trading on the American Stock

Exchange or the over-the-counter market. However, if the average p/e of similar companies in the industry is 15, then *Smith International* could be valued at \$1,800,000 (15 p/e times last year's \$120,000 net income) — still well above its reported tangible net book value of \$800,000.

That's why a comparison of the values arrived at by other methods is very important. All valuation methods are, after all, merely tools. The final, and best, valuation figure is often based on a combination of methods, and that's explained starting on the next page.

*Exhibit 1:* Eight Going-Concern Valuation Methods — see next page

*Exhibit 2:* IRS Revenue Ruling 59-60 — see page 14

*Tax Reference:* For both buyers and sellers, the tax treatment of goodwill, including noncompete, consulting, and employment contracts, is explained in Section #4, beginning on page 31. □

## Eight Going-Concern Valuation Methods

Here are the basic valuation methods by which businesses are valued. You want to use as many methods as possible. The more methods used, the more accurate your average and final, weighted value. Goodwill can be a very important part of a business' overall value. In many cases, a separate value for goodwill can be calculated and added to the company's value as computed by these methods.

- *Reported net book value:* This value is prepared by your accountant; it's simply the company's reported assets less all liabilities. To determine *tangible net book value*, simply subtract intangible assets, e.g., goodwill and capitalized financing costs, from reported net book value.
- *Adjusted net book value:* This method increases the company's net book value to the extent that certain assets (principally real estate, equipment, and inventory) exceed the cost basis of the assets as shown on the balance sheet. This approach usually increases the assets and thus the company's net book value.
- *Replacement value:* This value is used to determine the upside value of the business. Here all assets are written up to their replacement value and then the liabilities are subtracted. It can substantially increase a company's value and is principally used when selling a business to company executives or another company which wants to get into your line of business.
- *Liquidation value:* This value assumes liquidation of a company's assets and payment of all liabilities. It is used to determine the *absolute* minimum value of a business. *Example:* To determine the liquidation value of a business, you might apply a 25% liquidation value to inventory, 70% to accounts receivable, etc. You then subtract all liabilities to determine the liquidation value.
- *Price-earning's (p/e) multiple:* Here, you simply apply a comparable multiple, say 12, to the company's net income. If the net income is \$200,000, the value of the company is \$2.4 million. The faster the growth rate, the higher the p/e multiple. This is how most publicly held companies are valued.

- *Earnings before interest and taxes:* Referred to as EBIT, this method is similar to the p/e method described above. You determine the company's EBIT and apply a multiple to it, usually 4 to 8, principally depending on the company's growth rate, its profit margin on each dollar of sales, and other factors. *Note:* Some appraisers and analysts add depreciation and amortization expense to the formula for what is referred to as EBIT-DA.
- *Dividend value:* This method assumes the company pays out a certain percentage of its net income, say 50%. You average the last three years' net income, say, \$200,000. Then divide the \$100,000 dividend payout (50% times \$200,000) by a desired annual return, e.g., 8%, which results in a value of \$1,250,000 (\$100,000 dividend payout divided by 0.08).
- *Projected value of earnings:* This method applies a present value rate of about 15% to a company's projected net income. Basically, it is *today's* value of projected net income, usually over the next three to five years. The value can be recalculated to include depreciation and amortization expenses for a total *projected cash flow* value. This valuation method usually results in the highest value for a business whose earnings are expected to increase substantially in the near future. It is particularly appropriate for young companies which are growing very fast.

*Valuation adjustments:* When determining a company's earnings or net income, most valuation experts adjust the earnings for the following: (a) excessive owner compensation and fringe benefits, (b) extraordinary writeoffs of bad debts, unusable inventory, etc., and (c) the recapture of non-recurring expenses incurred in one year which benefit the company over future years ( e.g., establishing another sales office, research and development costs). Many times, an average of the last few years' earnings are used or they are weighted, e.g., a 50% weight to current earnings, 30% to last year's earnings, and 20% to the prior year's. You can do the same, particularly if your company's earnings are increasing every year. That will help maximize the value of the business.

*Weighted value:* The final step is to list the results from each valuation method and apply a "weight" (percentage allocation) to each value. Here's an example, assuming three of the valuation methods explained above. To get a conservative reading, we applied a greater weight to the adjusted net book value method, which is also less volatile than the other two methods because it doesn't involve earnings, which are more uncertain.

### Weighted Value of the Business

<u>Valuation Method</u>	<u>Value</u>	<u>Percent Weight</u>	<u>Weighted Value</u>
Adjusted Net Book Value	\$1,000,000	40	\$ 400,000
Price-Earning's Multiple	\$1,200,000	30	360,000
Projected Earnings	\$1,500,000	<u>30</u>	<u>450,000</u>
<b>Weighted Value</b>		<u>100</u>	<u>\$1,210,000</u>
<b>Average Value without Weights</b>			<u>\$1,233,333</u>

As computed, the weighted value of this business is \$1,210,000. However, *before* accepting the \$1,210,000 weighted value, it should be compared to the average value of \$1,233,333 (total values of \$3,700,000 divided by three) and the median value (\$1.25 million). Here are the comparisons. The final weighted value of \$1,210,000 represents:

- 98% of the average value of \$1,233,333.
- 97% of the median value of \$1,250,000.

As a general rule, when the weighted value is within 90% to 110% of the average and median values, you have a reasonable and good value. □

## **When to Use Revenue Ruling 59-60**

- You gift, sell, or transfer ownership to family members or others.
- Issue stock options to key executives or effect an employee stock ownership plan.
- Determine your estate tax liability.
- Effect a buy-sell agreement between stockholders (cross purchase) or with the company (stock redemption).
- Raise capital by giving options to buy stock or convertible securities, e.g., a venture firm lends your business \$500,000 with the right to convert the loan to common stock.

For IRS guidelines, please see the next page.

## **IRS Revenue Ruling 59-60**

An ownership position in a closely held company cannot be sold easily; it's unregistered stock and there isn't an established trading market. So determining a fair market value for the stock (or any illiquid ownership position) can be very difficult. Although the IRS also is hampered by the absence of a marketplace for the stock, it usually starts with net book value in its calculations and then factors in the following considerations:

- The economic outlook in general, and the condition and outlook of the specific industry in particular.
- The history and nature of the business being valued.
- The net book value of the stock (assets less liabilities) and the overall financial condition of the company.
- The company's projections of income and cash flow.
- Its dividend-paying history, as well as its *capacity* to pay dividends.
- The size of the block of stock being valued (majority or minority control, i.e., the number of shares being valued).
- Whether the stock being valued is voting or non-voting.
- Comparable values (e.g., price-earnings and EBIT multiples) for similar companies in the same industry.
- Prior stock sales and stock agreements (e.g., the purchase price set for stock options or a buy-sell agreement).
- The existence of goodwill and other intangible assets, such as licenses and patents.

*Reference:* The valuation guidelines above are contained in *IRS Revenue Ruling 59-60*. The ruling further states that "...all available financial data" and "other relevant factors affecting the fair market value of the stock..." also must be considered. □

## *Section #2*

# **How to Put a Dollar Value On Intangible Assets**

- **Accountant's Value**
- **Profit-Opportunity Value**
- **Cost-to-Create Value**
- **Cost-Savings Value**
- **Cost-of-Purchase Value**

**Even though a company's intangible assets may not have a dollar value in the financial statements, they can have a considerable operating value.**

As indicated, the value of goodwill is hard to determine and to document. Goodwill is principally the *intangible assets* in a business, such as a good customer base, a special manufacturing process, reputation in the industry, patents, etc. It's a value that is *not* usually shown on a balance sheet *or* its recorded net cost basis is zero or very much understated. *The reason:* Many intangible assets have been expensed over many years and achieve real operating value *only* after years of business activity.

This second part on valuing goodwill will discuss these five methods for arriving at a specific dollar value for an intangible asset:

- Accountant's Value
- Profit-Opportunity Value
- Cost-to-Create Value
- Cost-Savings Value
- Cost-of-Purchase Value

*There is a difference:* Section #1 valued goodwill by comparison with other companies in your industry. This section looks solely within the company to find intangible assets which increase its value.

### ***Method #1: ACCOUNTANT'S VALUE***

This method is used by accountants to record a purchase price for a business. An accounting entry for goodwill is needed when the total purchase price for a business exceeds the acquired company's net book value or net worth, i.e., the value of the assets acquired less all liabilities assumed in the purchase. For example, let's assume that a company is purchased for \$500,000 and has the following condensed balance sheet at the time of acquisition:

Assets	<u>\$800,000</u>
Liabilities	\$500,000
Net Worth	<u>300,000</u>
Liabilities and Net Worth	<u>\$800,000</u>

Since the company was acquired for \$500,000, the value assigned to goodwill is computed as follows:

Purchase Price	\$500,000
Less: Assets Minus Liabilities Assumed (\$800,000 Minus \$500,000)	<u>300,000</u>
Goodwill Value	<u>\$200,000</u>

Note that in this method, the value for goodwill is simply the excess of the purchase price (\$500,000) over the acquired company's net worth (\$300,000). This results in \$200,000 goodwill. *Tax note:* If you are selling your business, keep in mind that the buyer wants to write up assets (e.g., equipment and buildings) to fair market value. *Reason:* The value of goodwill must be written off over 15 years; in contrast, tangible assets, such as equipment, are written off (depreciated) over a shorter period, usually 3 to 7 years.

*Valuation note:* This type of goodwill, even though recorded on your balance sheet, may not have a real value when selling your business. Presumably, the company your business acquired, which brought about the goodwill amount, is reflected in your sales, profits, and assets.

## ***Method #2: PROFIT-OPPORTUNITY VALUE***

This method values a future income stream generated by an intangible asset. For example, suppose a company has a patented product or new product line that is expected to generate annual net profits of \$20,000 over the next ten years. Further suppose a present value rate of 15% is applied to these future earnings. With these assumptions, the value of the patent (i.e., the income stream of \$20,000 a year for 10 years) is determined as follows:

Average Profits	\$ 20,000
Present Value Factor (present value of an annuity for 10 years at 15%)	<u>x 5.02</u> *
Today's Value of Income Stream	<u>\$100,400</u>

\* For an explanation of present value, please see page 21.

Thus, today's value of the 10-year, \$200,000 total income stream from the patent is \$100,400. This is an important adjustment. It also is a value that is often overlooked because assets such as these are usually carried on company balance

sheets at a nominal value or zero, i.e., the development costs of the patented product have been fully expensed.

### ***Method #3: COST-TO-CREATE VALUE***

This method of valuing an intangible asset is based on the cost required to duplicate or replace the intangible asset. For example, suppose a company has developed a nationwide mailing list with the costs already fully expensed. For that reason, the mailing list carries no value on the company's balance sheet. However, its value, using this method, can be calculated as follows:

Labor to Compile Lists	\$18,000
Overhead Allocation (one-third)	6,000
List Purchases	14,000
Outside Services	<u>7,000</u>
Total Allocable Costs	\$45,000
Return on Investment (ROI): 12%	<u>5,400</u>
Today's Value of Mailing List	<u>\$50,400</u>

The first step is to identify all costs associated with developing (or producing) the intangible asset, whether a mailing list, product catalog, company brochure, or an audio-visual program to sell your products. After the costs are identified, you then apply a return factor on the money used to develop the asset. In our example, we used 12% for one year. Some companies use their actual return on investment (ROI), usually around 25%.

Again, keep in mind that the \$50,400 cost-to-create value is *in addition* to your company's reported net book value (stockholder's equity). *Reason:* The costs for developing the mailing list, product catalog, etc., were previously expensed, but these costs still represent a real value for an ongoing business.

### ***Method #4: COST-SAVINGS VALUE***

This method uses the cost savings that result from an intangible asset, such as a unique manufacturing process. To illustrate how to compute the value, let's assume that a special manufacturing process will save the company the following every year over the next five years:

<u>Cost Savings</u>	
Labor	\$ 20,000
Materials	<u>12,500</u>
Total Savings	\$ 32,500
Present Value Factor (present value of an annuity for 5 years at 12%)	<u>x 3.605</u>
Today's Value of Process	<u><u>\$117,162</u></u>

Thus, the value of the manufacturing process is \$117,162 for the five-year period. *Again, this value would not appear on the company's balance sheet.*

### ***Method #5: COST-OF-PURCHASE VALUE***

This method simply uses the actual cost of the intangible asset in the marketplace (today's cost vs. its purchase price years ago).

For example, a franchise or the rights to an exclusive territory would be valued by this method. Suppose, several years ago, a company obtained a fast-food franchise for \$50,000. In today's market, however, the same exclusive rights cost \$150,000. The cost-of-purchase method would value the existing franchise asset at its current value of \$150,000 — an additional \$100,000 value beyond the cost reflected on the company's balance sheet.

Market Value of Intangible Asset	\$150,000
<i>Less:</i> Cost Basis	<u>50,000</u>
Added Value	<u><u>\$100,000</u></u>

### ***Summary: Putting It All Together***

Recapping our analysis, this company's assets and its reported net book value would be *increased* by the following:

Income from New Product (page 17)	\$100,400	
Mailing Lists (page 18)	50,400	
Manufacturing Process (page 19)	117,162	
Excess Franchise Value (page 19)	<u>100,000</u>	
<b>Total Added Value</b>	<b><u>\$367,962</u></b>	(\$368,000)

Since the four adjustments above were either expensed (written off for tax purposes) or represent excess values over reported net book value, the \$368,000 is added to the company's net book.

*Example:* If a company's reported net book value was \$600,000, the total value (including intangible assets of \$368,000) would be \$968,000 *plus* any other adjustments to tangible assets, such as equipment, real estate, and inventory. If these tangible assets also were *understated* on the balance sheet, the excess amount (fair market value less depreciated cost) would further increase the company's value. For example, if these tangible assets (equipment, real estate, etc.) have a fair market value of \$350,000 and a depreciated cost basis of \$240,000, there is an *added* value of \$110,000. Thus, the total adjusted value of the business would be calculated as follows:

Reported Net Book Value	\$ 600,000
Value of Intangible Assets	368,000
Added Value of Tangible Assets	<u>110,000</u>
<b>Total Value of Business</b>	<b><u>\$1,078,000</u></b>

Please note that this \$1,078,000 total value represents 180% of the company's reported net book value of \$600,000.

\* \* \*

Every business has some element of goodwill — even if it is only the fact that it is established and operating. Thus, in any valuation process, goodwill must be given some consideration, particularly when selling a business. Be sure to identify and value these intangible assets and include them in your negotiations.

## **Explanation of Present Value and Annuity Analysis**

Present value is the value *today* of a sum of money or a projected income stream to be received in the future. For example, today's value of \$1,000 received three years from today at a 15% present value rate is \$658, a factor of .658 times \$1,000. This value analysis also applies to a *constant* income stream, referred to as an annuity. There are present value factors for annuities. For example, today's value of \$20,000 received every year over a 10-year period, using a 15% present value rate of an annuity, is \$100,400, a factor of 5.02 times \$20,000.

Present value tables can be found in most financial handbooks. The calculations also can be done easily on calculators and computers, or you can call your accountant for the present value factors. □

## *Section #3*

# **How to Identify and Protect Intangible Assets**

- **Your Products**
- **Your Processes**
- **Your Customers**
- **Intellectual Property**
- **Other Intangible Assets**

Patents ● Trademarks ● Trade Secrets

**If you don't treat a company secret as if it is a secret — under guard — then the courts may not consider it a secret at all.**

## **Have You Considered...**

- Protecting patents, trademarks, and trade secrets?
- Obtaining employment contracts with key employees?
- Keeping detailed records on research and product development?
- Limiting access to confidential data?
- Separating secret components and processes from the rest of production?
- Signing formal agreements with independent contractors?

**Legal protection is available that can block employees, independent contractors, and competitors from stealing your company's products, production processes, and customers.**

How would your company's sales and profitability fare if a competitor or former employee:

- Began to duplicate one of your products?
- Learned and adopted the production shortcuts and efficiencies you've worked so hard to develop?
- Directed advertising and promotional pieces to a customer list that your company has spent years developing?

The fact is, product designs, manufacturing processes, and customer lists are spirited away from companies and turned against them every day, despite the legal umbrella which management believes protects them.

Patent and trademark laws, trade secret laws, and employment contracts can help a company win reimbursement for improper use of its intangible assets. But your best approach is to protect against your assets being used against you in the first place. Here are some ideas on how to do it.

### **Types of Product Protection**

To safeguard a unique product development made at considerable company expense, legal protection can be sought. There are various options.

- A *utility patent* makes the unique patented features of a specific product the exclusive property of the company.
- A *design patent* makes the appearance and unique shape or form of a product the property of a company.
- A *trademark registration*, labeling a product or an entire series of products as an exclusive of the company, registers a distinctive company symbol or lettering for the sole use of the company.

### **Protect Products and Patents**

Although a patent deters less-than-ethical competitors from virtually duplicating a company's product or process, many businesses would rather not invest the time and expense involved in bringing legal suit against such competitors. A court injunction ordering a competitor to stop infringing on your patent may be difficult and costly to obtain, and litigation often takes years, so

patent owners often prefer to settle out-of-court for royalties on future sales or for a single cash settlement based on past and future sales.

Despite the considerable costs involved, many other companies decide to fight a patent infringement — primarily as a means of sending out a message to would-be infringers that the company intends to deal harshly with their actions.

You have two threats to be concerned about in protecting your products, processes, and customer base: those that originate within a company and those that originate outside.

**Threats from within.** When an employee quits and goes to work for a competitor, he or she may take with him one or more developments. Of course, he's breaking the law; legally, the property belongs to the former employer. But getting legal satisfaction is difficult and very time consuming.

*What to do:* Get legal protection by having each employee, as a condition of employment, sign a contract stipulating the following:

- The employee will promptly disclose, in writing, all on-the-job discoveries and inventions he makes.
- The employee is obligated to assign to you, the employer, all inventions and patents developed while working for the company, i.e., you are the legal owner of the property.
- The employee will not divulge research or other confidential information to unauthorized individuals within or outside the company.

If you haven't used these types of contract provisions in the past, it's not too late to start. Simply introduce them now and ask all already-on-the-job employees to sign them. You might even be able to make the terms retroactive to their employment date. Check with your lawyer.

**Threats from outside.** Your claim to a patent or process may be threatened by a counterclaim stating that the idea didn't originate with you. In that case, your best defense is in-house evidence of the *date* that the invention or process was conceived and accurate, dated records, drawings, and photographs of the development of the invention or special process.

To help establish this base of evidence for future protection, you can file written and pictorial details with the U.S. Patent and Trademark Office in the early stages

of product development and then file your Patent Application.

### **Protect Trade Secrets**

Patents take a long time to be granted and can be costly (often into five figures). That's why many companies simply begin producing and marketing their inventions and then rely for legal protection on trade secret laws.

Trade secret laws protect specific know-how if it is *intentionally* kept from outside knowledge. This protection can cover any device, pattern, formula, or compilation of information that is used in a business *or* gives an advantage over competitors who do not know or use it. Included under this protection are items that might qualify for a patent but that, for one reason or another, are not patentable — your special processes, material composition, machine design, etc. — as well as such "intellectual property" as marketing plans and customer lists.

The laws protect against anyone improperly obtaining that data through theft, abuse of confidence, or violation of a contract, such as a manufacturing or subcontracting contract. Courts can award damages to injured parties according to the extent of their loss of profits or the defendants' benefits.

**Practical protection.** Like patent litigation, bringing suit for theft of property under trade secret laws can be iffy and costly. These laws may not protect product information that competitors could learn by analyzing an unpatented product or process, or information obtained from observing an unprotected plant.

*You must make an effort:* Trade secret protection is available when a company can prove it made a determined effort to protect the idea or process from unauthorized employees or outsiders. In fact, victory can hinge on the extent of a company's actual efforts to maintain such secrecy.

### **Protect Against All Employees**

First, recognize that employees are a much more common source of theft than outsiders.

**Precaution #1.** Make employees thoroughly aware of the company's rules on patents, processes, customer lists, etc. Even without a written agreement, an employee is generally bound to the proper use of his employer's secrets and prohibited from divulging them to others. *Best approach:* Use a *written* agreement, which is a much stronger deterrent with employees. Be careful; enforcement of the

agreement depends on the reasonableness of the restrictions that you impose, so get expert advice on the wording of these agreements from a lawyer who specializes in patent and trade secret laws.

**Precaution #2.** The number of employees (and outsiders, of course) who have access to your company's secrets or to the area in which they're used should be kept to a bare minimum. If possible, you might physically separate the production work on a secret process or formula so that those who work with one part don't have access to the whole.

*Example:* Materials used — if basic to the trade secret — should be identified only by code or by suppliers' names; identification and composition information should be removed from packing material; and formulas should be kept locked up. Even if precautions such as these fail to prevent stealing, the fact that you had these policies in place will strengthen your case if you seek legal remedy through the courts.

### **Protect Customer Lists and Intellectual Property**

Customer lists that your company has compiled, including marketing and business plans, are considered your company's "intellectual property" under trade secret laws and, as such, they are entitled to the law's protection. Sales and marketing personnel who go into business for themselves or who go to work for a competitor may be tempted to remove and use the former employer's customer lists to get off to a fast start in a new job.

*Be aware:* Lists of potential customers compiled from directories or similar public sources may not be protected. But a company's "confidential" lists are protected, including: (a) the names of customers that the employee could *only* have learned about through his employment, and (b) the names of *potential* customers obtained on the basis of the company's past selling experience.

A salesperson can easily claim that his "customer/prospect list" has been obtained from sources other than his previous employer's lists (e.g., his memory), or that he had known about them prior to his employment. In that case, your protection is a written agreement with those employees that they will not compete against the company for a specific period of time after they leave the company, and within a certain geographic area.

## How Noncompete Agreements Work

*Here are examples:*

1. Courts barred a salesperson from doing business with a customer of his former employer — even though the customer said he had planned to cease doing business with the former employer anyway.
2. Courts barred a business-forms salesman from selling a competing line to his former employer's customers for two years after his employment ended.

*Trend favors employees:* Noncompete agreements risk disqualification if they are judged to be unnecessarily restrictive to the employee or an unfair barrier to that employee's ability to make a living. Also be aware that the trend in court cases continues to favor the employee. For example, one court threw out a contract prohibiting a bowling equipment salesman from selling a similar line anywhere in the United States for five years. Other courts have thrown out agreements restricting former employees from selling in geographic areas in which the previous employer had no business dealings.

In another case, a hairdresser went to work for an employer and signed an agreement not to compete as a hairdresser for two years after leaving and within a five-mile radius. The hairdresser subsequently left her employer and started working for a competitor two miles away. *Result:* The court refused to enforce the noncompete since it would restrict the hairdresser from earning a living.

## Protect Against Non-Employees

Special precautions also should be taken to protect company secrets and assets from theft or misuse by independent contractors and consultants who may be brought into the company for a limited period of time to complete a special project. During the time they are working for you, these "independents" often have access to privileged "insider" information on company records, products, and operations.

*What to do:* A written agreement should be signed by all independent contractors, specifying the purpose and objectives of the assignment for which they are being hired, the fees to be paid, and any deadline dates that may apply. For additional protection, the agreement should include these provisions:

- **Rights to work done.** Provide that all the work done by the independent contractor is the property of the company.

- **Rights to information obtained.** Have the independent sign an agreement not to disclose proprietary aspects of the business or talk to others about your operations without your prior *written* consent.
- **Rights to materials used.** Specify that all information used or referred to in the completion of the project will be returned. Include memoranda, charts, slides, market research, etc.
- **Rights to indemnification.** The independent contractor may be representing your company to other people. Have him personally and his firm indemnify you for any wrong acts or misuses of the information you give him.

\* \* \*

You don't have to become paranoid in guarding your company secrets and products from theft by disgruntled or former employees, unscrupulous contractors, or unethical competitors. But you don't want to be reckless, either, in exposing your company to unnecessary risks.

There is no way to eliminate all risks that your company's "special assets" won't be used against it, but the ideas in this section will help you minimize that risk.

*Reference:* For more information on Patents and Trademarks, please see the next page. □

## Patent and Trademark Information

For patent and trademark application information, contact:

U.S. Patent and Trademark Office  
Mail Stop USPTO, Contact Center (UCC)  
PO Box 1450  
Alexandria, VA 22313-1450

Main Office: 800-786-9199  
E-mail: [usptoinfo@uspto.gov](mailto:usptoinfo@uspto.gov)  
Website: <http://www.uspto.gov>

**To order** — For the following booklets, contact the U.S. Patent and Trademark Office at the address and numbers above:

- *General Information Concerning Patents* — free
- *Products and Services Catalog* — free
- *Information Contacts* — free
- *Basic Facts About Trademarks* — free
- *Design Patent Application Filing Guide* — free
- *Utility Patent Application Filing Guide* — free

*Please note:* The booklets above usually change every year or two.

## ***Section #4***

# ***Sale and Purchase of a Business: Goodwill and Deal Structure***

- **Tax Rate Analysis**
- **Goodwill and Intangible Assets**
- **Negotiating Strategies**
- **Deal Structure**

**Run afoul of the tax laws and you could pay a big price in unexpected taxes.**

Planning to sell your business or looking at another business to buy? To start, you should be aware of some important tax provisions which can substantially affect the final price. Keep them in mind when planning for the transaction, negotiating it, and computing the bottom line of any sale or purchase: the *after-tax cash* you will receive from the buyer or pay the seller.

Here also are negotiating ideas on how to structure the transaction to obtain more money and increase your after-tax cash if you're the seller and to reduce your cash outlay and maximize your tax advantages if you're the buyer.

Some tax facts for the seller and the buyer to be aware of in the discussion that follows:

- The maximum tax rate on long-term capital gains (held for more than 12 months) is 15% and 0% for 10% and 15% tax bracket taxpayers, principally children and some retirees.
- The maximum tax rate on real property capital gains is also 15%. However, the tax rate is 25% on depreciation deductions taken on prior tax returns, referred to as recapture.
- The maximum tax rate on personal income over \$372,950 (married, filing jointly) is 35%. See page 39 for Personal Tax Rates.

Now to some basic tax rate and asset purchase/sale analysis.

**#1. The high tax rates on personal income.** The maximum 35% personal tax bracket, coupled with the disallowance of itemized deductions and personal exemptions, could result in income being taxed at an effective tax rate of more than 40%, not counting state and local taxes, which also can add another 5 to 10 percentage points. In contrast, the tax rate for long-term capital gains is at 15% for most taxpayers, a difference (tax savings) of 20 percentage points when compared to the 35% maximum personal tax rate.

Thus, when negotiating the sale of your business, you want as much of the profit on the sale as possible classified as a long-term capital gain. That means allocating more of the selling price to hard assets (e.g., real estate, plant, equipment) and more to goodwill, all of which are taxed at the maximum capital gain rate of 15%. In contrast, a consulting agreement or a covenant not to compete is taxed as personal income at tax rates up to 35%. The difference in the tax treatment is dramatic: For every \$100,000 classified as a capital gain rather than personal income, *you save \$20,000* in federal taxes.

Here's the basic math and tax savings, not including potential state and local tax savings.

**Per \$100,000 of Capital Gain —**

Taxed as Personal Income (35% Tax Rate)	\$35,000
Taxed as a Capital Gain (15% Tax Rate)	<u>-15,000</u>
Tax Savings if Classified as a Capital Gain	<u>\$20,000</u>

**#2. The writeoff period on goodwill and intangible assets.** For the buyer, the value of purchased goodwill is capitalized and written off over 15 years. For the seller, this goodwill is treated as a capital gain, which qualifies for the maximum tax rate of 15%. For the buyer, intangible assets are also written off over 15 years. These intangibles include licenses, permits, patents, copyrights, etc.

It's important for both tax and negotiating purposes that the seller and buyer know in advance the tax treatment and writeoff periods of all assets. Here is a listing to discuss with your advisers.

**Goodwill and Intangible Assets — The Tax Law**

**What's included in the 15-year writeoff —**

- goodwill and going-concern value,
- workforce in place,
- information base and know-how,
- customer-based intangibles,
- supplier-based intangibles,
- licenses, permits, copyrights, patents, or other rights granted by a governmental unit or agency,
- any covenant not to compete entered into in connection with the acquisition of a trade or business or a substantial portion of the trade or business, and
- any franchise, trademark, or trade name.

**What's *not* included in the 15-year writeoff —**

- accounts receivable or other similar rights to income for goods and services,
- interests in a corporation, partnership, trust or estate,

- interests under certain financial contracts,
- interests in land,
- certain computer software,
- certain separately acquired rights and interests,
- interests under existing leases of tangible property,
- interests under existing indebtedness,
- sports franchises,
- certain residential mortgage servicing rights, and
- certain corporate transaction costs.

## Negotiating Strategies and Structure

Here are some deal structure and negotiating tips *from the seller's viewpoint*; for buyers, just reverse the approach. The many ideas should be discussed with your advisers *before* serious negotiations begin.

**#1. Value of assets.** The sale of goodwill is preferable to a covenant not to compete or a consulting agreement since goodwill produces a long-term capital gain, which is taxed at a maximum rate of 15%. The buyer may not object to a higher goodwill amount, since the value of goodwill is written off over 15 years, the same as a covenant not to compete. It makes no tax difference to the buyer which of the two assets is valued higher, i.e., the goodwill or the noncompete agreement.

**#2. Payout period.** The buyer may want to match the payments due you on a covenant not to compete or other intangible assets to the length of the write-off period, i.e., 15 years. However, be very careful; it's always preferable to *get paid today*, not over future years. If you must do an installment payout, limit the payout to three to five years, obtain collateral, e.g., a lien on the assets or shares of stock being sold, and try to limit the installment note to no more than 25% of the total purchase price.

**#3. Consulting agreement.** You may be asked to allocate more of the purchase price to a consulting agreement since the payments to you are tax

deductible by the buyer *as they are paid* and are not subject to the 15-year amortization writeoff.

*Precautions:* For the seller, all consulting and employment payments are taxed at personal income tax rates (up to 35%) and the annual and total amounts paid to you must be in a range the IRS considers reasonable. For example, you can't be making \$80,000 a year now and set up a five-year consulting/employment agreement worth \$300,000 a year. Be aware of this if the buyer wants to set a *higher* consulting contract in exchange for a *lower* purchase price; the IRS may do its own allocation of the total funds paid by the buyer and received by the seller.

**#4. Separate the selling price from services.** You are entitled to *extra* monies if you are going to be a consultant or employee of the company. These payments should *not* be part of the purchase price for the company itself. It's best to negotiate a consulting or employment contract as a *separate* agreement.

**#5. Stock vs. asset sales.** The current law makes stock sales, rather than asset sales, more attractive. As a seller, the payment you receive for a stock sale is taxed as a long-term capital gain, a big plus. And the buyer may be more receptive to a stock purchase because the tax writeoffs on the purchase of intangible assets are stretched out over 15 years. *Result:* As a seller of stock rather than select assets, you may be more willing to accept a somewhat lower selling price for your business to offset the benefit of having the amount taxed as a capital gain rather than personal income. Sophisticated buyers are fully aware of this and will use it in their negotiations.

*Cautions on stock sales:* If you are accepting stock in exchange for your business, be sure you fully understand and believe in the acquiror's stock. Also, if the buyer is a publicly held company, try to get *registered stock* so you can sell the shares in the public market. If the buyer is a non-public company, accepting stock involves more risks and should be carefully analyzed with your advisers. Basically, you are moving from one illiquid position (your company's stock) into another illiquid position. Furthermore, your new ownership position is with a company you aren't managing, so its growth and profitability are under someone else's control, not yours. That's why so many business owners are uncomfortable with selling out via a stock-for-stock exchange.

But there are benefits to a stock sale. It can be less hassle to effect and there's no bulk sales tax associated with the transaction. In addition, as indicated,

stock sales, in contrast to asset sales, usually result in the assumption of all liabilities by the buyer, a big plus for the seller.

\* \* \*

Get good advice *before* starting negotiations on the purchase or sale of any business. For your use, more negotiating ideas and the personal tax rates are presented on the following pages. □

**One of your top priorities should be qualifying the sale as a capital gain.**

## ***Selling Your Business: More Negotiating Strategies***

□ Have alternatives and counteroffers ready in advance. Good deals are built on a series of concessions and compromises.

□ Don't even open negotiations if you don't have some evidence that the buyer has sufficient resources to purchase your business. If the buyer's resources are marginal, you may have trouble negotiating a fair price.

□ Know why the buyer is interested in your company. Identify his or her motives for wanting to buy your company.

□ Concentrate on the big issue — the price: how much, in what form (cash or notes), and when you will get the money (at closing and/or over a period of time).

□ Market your company. Be prepared to profile your company in writing, fairly and concisely. Know how to convey the strong aspects of your business and its potential for growth and profit.

□ Reconstruct the financial statements *before* putting a price tag on the business. Know your *adjusted* pre-tax and after-tax income. Know *both* the fair market and replacement values of the assets.

□ Know your company's value to the buyer; compute the *buyer's* after-tax purchase cost.

□ Don't nitpick. Make a listing of your needs in the order of priority and then work on them in that order.

□ Don't overclose and don't oversell. When it's time to end the discussion, do so. That time is usually after the price is determined: how much, in what form (cash, notes, etc.), and when it will be paid. Leave the rest of the details to your professionals.

□ Mathematically document the price you want and list *all* the benefits to the buyer. Determine the buyer's projected cash flow (after taxes), including depreciation and the writeoff of goodwill and a noncompete agreement. Knowing what your company is costing the buyer is an important and powerful negotiating tool. The buyer's actual cost to acquire the business should be much less than the stated selling price you're being paid, usually about 70%.

□ If the buyer is a public company, multiply your company's *adjusted* net income by the buyer's price-earnings multiple. That will give you a valuation on your business from the perspective of the buyer.

□ If real property is involved in the sale of your business, separate it from the business and *price it independently*. Also identify and negotiate separately your company benefits: pensions, life and health insurance, company car, deferred compensation, etc. Establish their value and their continuation in advance; make these benefits part of your negotiations and the closing documents.

□ Avoid contingency deals where your pay-out is dependent on your company's future profits and/or sales. Remember that you have given up control.

□ If you want no strings and no worries, sell your company for *all* cash.

□ Remember this also — the worst negotiating position for a seller is when he or she needs to sell. Even if this is the case, the best approach is to be receptive to offers *without* appearing in a hurry to close the deal. You can be accessible and responsive to a prospective buyer without appearing unduly anxious. □

*Personal Tax Rates* — please see next page.

## Tax Rates and Taxable Income for 2009

**Table 1 — Personal Tax Rates for 2009 — Married, Filing Jointly and Single Taxpayers (see box below)**

**Note** — Personal Tax Rates also apply to the owners of S Corporations, Partnerships, Limited Liability Companies, and Sole Proprietorships.

<u>2009 Tax Data Taxable Income</u>	<u>Marginal Tax Rate</u>	<u>Taxes Payable</u>	<u>Cumulative Income</u>	<u>Cumulative Taxes</u>	<u>Overall Tax Rate</u>
First \$16,700	10%	\$ 1,670	\$ 16,700	\$ 1,670	10.0%
Next \$51,200	15%	\$ 7,680	\$ 67,900	\$ 9,350	13.8%
Next \$69,150	25%	\$17,287	\$137,050	\$ 26,637	19.4%
Next \$71,800	28%	\$20,104	\$208,850	\$ 46,741	22.4%
Next \$164,100	33%	\$54,153	\$372,950	\$100,894	27.1%
Over \$372,950	35%				

**Table 2 — Range of Taxable Income for 2009**

<u>Married, Filing Jointly</u>	<u>Single Taxpayers</u>	<u>Tax Rate</u>
\$0 to 16,700	\$0 to 8,350	10%
\$16,701 to 67,900	\$8,351 to 33,950	15%
\$67,901 to 137,050	\$33,951 to 82,250	25%
\$137,051 to 208,850	\$82,251 to 171,550	28%
\$208,851 to 372,950	\$171,551 to 372,950	33%
Income over \$372,950	Income over \$372,950	35%

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