

Structuring The Intellectual Property Analysis Assignment

By Robert F. Reilly

Introduction

Valuation analysts are often called on to analyze intellectual property for such purposes as: sale or license structuring, transaction fairness opinions, financial reporting and fair value accounting, federal income tax, *ad valorem* property tax, financing collateral, bankruptcy and reorganization, and litigation support and dispute resolution (including breach of contract, infringement, and other tort claims). For purposes of this discussion, intellectual property includes patents, copyrights, trademarks, and trade secrets. And, for purposes of this discussion, valuation analysts include licensing executives, business appraisers, academics, economists, forensic accountants, and other professionals.

This discussion summarizes the ten typical stages of any intellectual property analysis assignment. For purposes of this discussion, such an intellectual property analysis may include a valuation, damages analysis, transfer price study, or other economic analysis. The analyst will typically consider these stages, or elements, before, during, and after performing any quantitative or qualitative analyses. This is because consideration of these engagement elements typically makes (1) the subject analysis more efficient and (2) the selected analytical procedures more effective. And, this is because the consideration of these engagement elements typically make the analysis conclusion more credible, replicable, and supportable. Each of these ten engagement elements is summarized below.

Understand the Analysis Purpose and Objective

A clear and concise statement of understanding of the purpose and objective of the analysis will help the analyst throughout the engagement. Such an understanding will help the analyst plan and execute the analysis. And, such an understanding will help keep the analyst on track throughout the various stages of the analysis.

The first component of the purpose and objective of any intellectual property analysis is a complete description of the subject intellectual property. Before quantifying any valuation, damages, or other conclusion, the analyst should understand what intellectual property (and what related intangible asset, if any) is included in the analysis. A detailed written description of the intellectual property should allow a report

reader (or other interested party) to understand the scope of the intellectual property (or properties) encompassed in the subject analysis. With regard to a complex owner/operator, a complex litigation, or a complex transaction, such a written description will also help the report reader (or other interested party) to understand what assets (tangible or intangible) are not included in the subject analysis.

The second component of the analysis purpose and objective is a description of the intellectual property subject property rights. An inexperienced analyst may naively assume that the subject bundle of rights is a fee simple interest.

That assumption may coincidentally prove to be correct. However, many intellectual property valuation, damages, or transfer price analyses involve consideration of either a fractional ownership interest or a limited term interest. Differences in the subject bundle of legal rights can materially affect the intellectual property analysis conclusion.

The third component of the purpose and objective is a definitive statement of analysis objective. Unfortunately, owner/operators, legal counsel, and others are often imprecise when they describe the intellectual property assignment to the analyst. Such client parties often call the engagement a valuation when the defined value of the intellectual property is not the analysis objective. Before the engagement begins, the analyst, the client, legal counsel, and any other interested parties should understand if the analysis objective is to conclude a defined value, a fairness opinion, a solvency opinion, an exchange ratio (or a reasonably equivalent value), a royalty rate, a license fee, a damages measure, a transfer price, or some other conclusion.

The fourth component of the purpose and objective relates primarily to a valuation assignment. That is, if the engagement objective is to conclude an intellectual property value, what is the appropriate standard of value? The standard of value is typically defined as the definition of value. And, for the most part,

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the standard of value answers the question: value to whom? Before the valuation engagement begins, all parties should agree whether the intended standard of value is fair value, fair market value, owner value, use value, investment value, acquisition value, or some other standard of value.

The fifth component of the purpose and objective is the analysis as of date. Typically, the client or the legal counsel will inform the analyst of the appropriate as of date. That date will often relate to a specific transaction, transfer, license or contract, damages event, regulatory filing, or other reason to conduct the analysis. It is often helpful for the analyst to understand the significance of the selected as of date. The analysis date can either be historical (often called retrospective), contemporaneous (often called current), or prospective (that is, in the future). The analyst should also know if the analysis involves a series of dates, such as (1) a license agreement start date and stop date or (2) a damages period first event date and a damages period termination date.

The sixth component of the purpose and objective is a clear statement of the purpose of the analysis. The purpose of the analysis explains why the analysis was prepared. The purpose may also state (or at least indicate) who may rely on the results of the analysis. While there are numerous individual reasons to prepare any intellectual property analysis, most of these individual reasons may be grouped in the following categories of purposes:

1. Notational—for example, for financial accounting, regulatory compliance, or management information purposes.
2. Transactional—for example, for sale, license, transfer, financing, or similar reasons involving an actual exchange of the subject asset or of cash.
3. Litigation—for example, a measurement of value or damages to convince a finder of fact in a contemplated or actual litigation.
4. Taxation—for example, for income tax, gift or estate transfer tax, or property tax planning or compliance.
5. Other—for example, any other purpose that does not fit one of the above-mentioned categories.

Consider the Intellectual Property Highest and Best Use

The analyst's consideration and conclusion of highest and best use (HABU) affects each type of intellectual property analysis. HABU considerations

affect intellectual property value, damages, transfer price, and other analysis conclusions. This is because the HABU conclusion affects whether the subject analysis considers the intellectual property as part of the following transactional scenarios (1) as a stand-alone, individual asset, (2) as part of an assemblage with other, related intangible assets, or (3) as part of a going concern business enterprise. Often, the client or the legal counsel instructs the analyst as to the appropriate HABU assumption, often called the appropriate premise of value. However, without such an instruction, the analyst may have to select the premise of value that concludes the intellectual property HABU.

The criteria that the analyst typically uses to assess an intellectual property HABU are the same as the criteria that an appraiser typically uses to assess a tangible asset's HABU. The four typical criteria for HABU are:

1. Legal permissibility—the selected transactional premise must be legal.
2. Physical possibility—the selected transactional premise must be physically possible.
3. Financial feasibility—the selected transactional premise must provide a fair rate of return to the owner/operator.
4. Maximum productivity—the selected transactional premise must result in a higher value than the remaining alternative physical possibility—the selected transactional premise must be physically possible.

Discount the Above-Listed Elements in an Engagement Letter

The analyst can be an independent contractor working for a third party owner/operator. Or, the analyst can be an executive working for an employer owner/operator. In either case, it is a best practice for the analyst to document each of the above-described elements of the analysis in some form of written documentation. Typically, the independent analyst will prepare a written engagement letter for the client or the client's legal counsel. Typically, the employee analyst will prepare a written assignment memorandum for the supervisor or for the assignment file.

In both cases, the valuation analyst will describe the intangible asset assignment purpose and objective. Such documentation is a best practice because it helps ensure that the analyst and the client (or the employer) have a consistent understanding of the assignment. Such documentation alleviates the potential for misunderstanding between the parties.

And, such documentation serves as a guideline for the analyst throughout the assignment. That is, the analyst can refer to the engagement letter (or memo) to ensure that the analyst is actually performing the analysis he or she set out to prepare.

The engagement letter will typically document important assignment due dates. Such due dates may include:

1. When the client (or employer) needs the quantitative analysis results.
2. When the client (or employer) needs a written analysis report.
3. The expected date of trial testimony, a board presentation, a regulatory hearing, or other presentation event.
4. Dates of any other deliverables, such as audit assistance, negotiation between contract counterparties, litigation support, or any other post-report activities.

The engagement letter should document not only the date of any other deliverables, but also the scope of any other deliverables. That is, the letter (or memo) typically documents any continuing analyst commitment to periodically update the analysis, appear before taxation or other regulatory authorities, be named as a valuation expert in a Securities and Exchange Commission filing or other public document, be named as a testifying expert, etc.

Determine the Appropriate Type of Report

The instruction as to the appropriate report form and format will typically come from the client or legal counsel. The analyst should be aware of the type of report that the client needs. The analyst should also generally be aware of why the client needs the specified type of report (*e.g.*, for tax compliance, regulatory compliance, litigation, or other purposes). The analyst should understand the required report type from the inception of the engagement. That way, as each analysis is performed, the analyst can consider how that analysis can be described in the final report.

There are several forms and formats of reports that may be appropriate to the intellectual property analysis. The following report type descriptions are intentionally general. That is, the following report titles do not comply with the Uniform Standards of Professional Appraisal Practice (USPAP), the American Institute of Certified Public Accountants (AICPA) Statement on Standards for Valuation Services (SSVS), or any other specific organizational standard that the analyst may intend to comply with. That is because the aforementioned professional standards only apply

to valuation engagements. In contrast, the following general report format descriptions are applicable to all types of intellectual property analyses.

1. **Memo report**—Often, a client or employer only needs a memorandum that states the analysis assignment, methodology, research analyses, and conclusions; such a memo report may or may not include schedules or exhibits that summarize the related quantitative analyses.

2. **Opinion report**—Many types of reports have a typical format that is generally accepted by practitioners within the professional community; some examples of such opinions include fairness (for a sale or license transaction) opinions, solvency opinions, and others.

3. **Summary report**—This type of report typically summarizes the analysis assignment, methodology, analyses, and conclusion; this type of report may not include all of the analyst's supporting work and all of the data sources relied upon; however, this type of report typically includes sufficient schedules and exhibits to allow the report reader to replicate the subject analyses and confirm the subject conclusion.

4. **Narrative report**—This type of report format typically describes the analysis assignment, methodology, analyses, and conclusions sufficiently to allow the reader to recreate the analyst's thought process; this report type typically includes virtually all of the analyst's supporting work and the data sources relied upon; this report type typically includes detailed schedules and exhibits to allow the report reader to replicate all of the quantitative and qualitative analyses and to recreate the subject conclusion.

5. **Oral presentation**—Much like a written memo report, often the client or employer only needs a summarized presentation of the analyst's work and conclusion; the oral presentation may be accompanied by a presentation flipchart that includes an outline of the points made by the analyst during the oral presentation; such a presentation is common when the analyst is advising the owner/operator or other parties with regard to management decision-making; such an oral report format is usually not applicable in an adversarial (*e.g.*, litigation) environment.

6. **Oral testimony**—This type of oral report is usually presented in an adversarial environment where the analyst may be testifying under oath or at least is subject to some form of adversarial review; in such an oral report, the analyst may completely

describe all elements of the analysis assignment, methodology, analyses, and conclusion; the oral testimony may also be accompanied by either a summary written report or a narrative written report.

Intellectual property analysts should be aware that the expert report prepared for litigation purposes may have to comply with specific reporting standards. The analyst should confer with legal counsel regarding the appropriate report form and format for the subject jurisdiction. For example, in a matter litigated in a federal court, the analyst's report may have to comply with the Federal Rules of Evidence Rule 26 regarding the admissibility of expert reports. Again, the analyst should obtain legal instruction from counsel with regard to the form and format of such an expert report.

Consider Applicable Professional Standards

The analyst should consider if there are any professional standards that apply to the development of the analysis, the reporting of the analysis results, or both. The extent to which certain professional standards apply to the subject analysis is a function of both (1) the type of intellectual property analysis and (2) the type of intellectual property analyst. For example, different standards may apply to a valuation engagement, economic damages engagement, transfer price study, or other type of intellectual property analysis. And, different standards may apply, for example, to a certified public accountant (CPA) compared to a non-CPA performing the same analysis.

CPAs who perform intellectual property valuations will comply with the AICPA Statement on Standards for Valuation Services (SSVS). CPAs who perform intellectual property damages analyses will comply with the AICPA Statement on Standards for Consulting Services (SSCS). And, CPAs who perform intellectual property transfer price analyses for income tax purposes will comply with the AICPA Statement on Standards for Tax Services (SSTS).

Members of various professional organizations also perform intellectual property valuation services. Such analysts will comply with the professional standards promulgated by the organizations of which they are members. For example, the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), and the National Association of Certified Valuation Analysts (NACVA) all have professional standards that may apply to intangible asset (including intellectual property) valuations. The Uniform Standards of Professional Appraisal Practice (USPAP) contains standards rules that relate to intangible asset (including intellectual property) appraisals. Certain intellectual property appraisers will comply with

USPAP when such compliance is required by either (1) law, (2) regulation, or (3) an agreement with the appraiser's client.

Nonetheless, there are no all-embracing professional standards with which all analysts should comply with regard to intellectual property valuations. For example, economists, academics, industry analysts, licensing executives, or financial planners who perform intangible asset valuations do not need to comply with any of the above-mentioned professional standards. The same statement is true with respect to intellectual property damages analyses. Other than AICPA professional standards and practice aids that apply to CPAs, there are no other economic damages professional standards that apply to non-CPA analysts. Likewise, there are no promulgated professional standards for other intellectual property analyses such as exchange ratio measures, license royalty rate studies, remaining useful life (RUL) and amortization studies, etc. All analysts who perform intercompany transfer pricing studies for federal income tax purposes will comply with the procedural guidelines listed in the Treasury Regulations related to Internal Revenue Code Section 482. However, there are also no professional standards related to intellectual property transfer price analyses.

The above discussion relates specifically to promulgated professional standards. The lack of standards for certain types of analyses and for certain types of analysts should not imply that there are not best practices related to all intellectual property analyses. These best practices are incorporated in generally accepted professional practices and procedures. However, these best practices may not be documented in written professional standards. Nonetheless, any analyst should be prepared to justify a departure from the generally accepted professional practices with respect to any individual intellectual property analysis.

As mentioned above, there are evidentiary requirements related to any intellectual property analysis performed for litigation purposes. Such requirements involve whether the judicial finder of fact will accept the analyst's expert report and expert testimony as evidence in the particular proceeding. These rules of evidence vary between the various federal courts, between federal and state courts, and between the various state courts. Intellectual property analysts should obtain legal instructions from the client's counsel regarding (1) the applicable rules of evidence and (2) the analyst's compliance with the applicable rules of evidence.

Assemble and Supervise Appropriately Trained Staff

Unless the subject analysis is particularly simple, it is not uncommon for a supervisory analyst to assemble and work with a team of intellectual property analysts. In such instances, the supervisory analyst is usually the individual (1) who has overall responsibility for the engagement, (2) who will reach the final value, damages, transfer price, etc. conclusion, and (3) who will sign the analysis written report and/or deliver the analysis oral report.

In such cases, the supervisory analyst should ensure that all members of the engagement team

1. Have adequate experience and expertise to work on the analysis.
2. Are adequately trained and supervised throughout the engagement.
3. Have a sufficient understanding of the elements of the assignment.
4. Have a sufficient understanding of the assignment time and fee budget.
5. Have a sufficient understanding of the assignment deliverables.
6. Have a sufficient understanding of the analysis documentation requirements.

Of course, the supervisory analyst should ensure that each team member understands his or her role in the preparation of the analysis development and of the analysis report.

Collect and Confirm Sufficient Data to Perform the Analysis

Whether or not the analyst has a team of assistants, the analyst is ultimately responsible for the adequacy of the data collection and due diligence procedures. In most types of intangible asset analyses, the analyst may collect and synthesize five categories of data:

1. Owner/operator documents—including a description of the owner/operator, a description of the use of the intellectual property, historical financial statements, and prospective financial statements.
2. Intellectual property data—including information about the intellectual property age, original development, maintenance activities, current use in the owner/operator business operations, and expected future use in the owner/operator business operations.
3. Subject transaction documents—including documents related to an ownership, transfer, license, financing, pending

litigation, or any other event that is the subject of the intellectual property analysis.

4. Industry data—including information about the industry that the owner/operator competes in and about any industry that can (or does) use the subject intellectual property.
5. Comparable transaction data—including data regarding comparable companies to the owner/operator, sales of comparable intellectual property, and licenses of comparable intellectual property.

Select and Perform the Appropriate Analysis Methodology

The experienced analyst is aware that there are generally accepted methods and procedures related to each type of intellectual property analysis. That is, there are generally accepted methods and procedures related to intangible asset valuations, damages measures, transfer price studies, and other analyses. In each particular analysis, the analyst will apply the most appropriate methods based on:

1. The quantity and quality of available data.
2. The purpose and objective of the analysis.
3. The specific factors related to the subject intellectual property.
4. The specific factors related to the subject intellectual property transaction.
5. The analyst's perception of the methods used by actual market participants.

Ultimately, the analyst will rely on his or her reasoned judgment and professional experience in the selection of the appropriate analysis methods. Relying on that judgment and experience, the analyst should be prepared to explain the reasoning for (1) accepting the analysis methods that were used and (2) rejecting the analysis methods that were not used. In addition, the analyst should be prepared to explain any departures from the generally accepted methods and procedures that are applicable to the subject analysis. In particular, the analyst should expect to explain any such departures in an intellectual property analysis prepared for litigation purposes.

Reach a Replicable and Well-Supported Analysis Conclusion

The synthesis and conclusion of any intellectual property analysis is ultimately the responsibility of the principal analyst. Like the selection and application of the analysis methods, reaching the final analysis conclusion is ultimately a matter of the analyst's judgment and experience.

In reaching a final analysis conclusion, the analyst will consider if there are any applicable regulatory considerations. For example, the conclusion of an intellectual property royalty rate is usually based on a synthesis of the results of several royalty rate estimation methods. However, the conclusion of an intellectual property intercompany transfer price is typically based on the result of a single analysis method. This is because the regulations related to Internal Revenue Code Section 482 require the analyst to apply the so-called best method rule. That is, the analyst will select and apply the most appropriate of the allowable transfer price methods. And, then the final transfer price conclusion is based on the application of that single best method.

Typically, the analyst will consider all indications from all methods in synthesizing the final analysis conclusion. The analyst will typically reconcile all of the analysis indications to reach a weighted average overall conclusion. Some analysts prefer to use a qualitative weighted average procedure, assigning a specific weighting percentage to (say) the method A conclusion versus the method B conclusion versus the method C conclusion. Other analysts prefer to assign a more qualitative weighting to the various analysis indications. For example, without specifying percentages, the analyst may apply (say) the most weight to the method A conclusion, less weight to the method B conclusion, and the least weight to the method C conclusion.

Regardless of the reconciliation procedure used, the analyst's objective is to make the subject analysis conclusion as replicable and as transparent as possible. That way, another analyst can duplicate (and verify) the analyst's reasoning and conclusion. Also, a replicable, transparent conclusion is usually more convincing to the analyst's client, the client's legal counsel, the finder of fact, or any other interested party.

Prepare a Well-Documented and Well-Reasoned Analysis Report

In preparing a report (written or oral) that is meaningful to the client and to other interested parties, the analyst will consider if the report complies with the

assignment requirements. In particular, the analyst will consider if the analysis and the report achieve both the purpose and objective of the assignment. In particular, the analyst will consider if the report complies with:

1. Any applicable professional standards (including any litigation-related requirements).
2. The terms and conditions of the engagement letter or engagement memo.
3. The informational needs of the client (or any other interested parties).

For intellectual property analyses prepared for litigation or related purposes, the analyst will consider if the report work product complies with all applicable litigation, taxation, regulatory, or other requirements. If the analyst is not absolutely sure of the appropriate requirements, then he or she should consult with the client's legal counsel.

Summary and Conclusion

There are normally ten stages to most intellectual property analyses. These ten stages are typically applicable to an intellectual property valuation, damages analyses, transfer price study, or other type of analysis. In performing the intellectual property analysis, the analyst will:

1. Understand the assignment purpose and objective.
2. Conclude the intellectual property HABU.
3. Document the assignment elements in an engagement letter or memo.
4. Consider the appropriate report form and format.
5. Apply any applicable professional standards.
6. Train and supervise the engagement team.
7. Collect and confirm sufficient data.
8. Select and perform the appropriate methodology.
9. Reach a well-supported analysis conclusion.
10. Prepare a well-documented analysis report.

The effective structuring of the intellectual property analysis assignment should result in (1) the efficient development of the analysis and (2) the clear reporting of a well-supported analysis conclusion. ■