Intangible Asset Valuation and Damages Analyses

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Discussion Outline

- What is and what is not an intangible asset
- Examples of intangible assets and intellectual property
- Types of intangible asset analyses
- Litigation and other reasons to analyze intangible assets
- Intangible asset valuation approaches and methods
- Intangible asset valuation considerations
- Intangible asset damages measurement methods
- Intangible asset damages measurement considerations
- Valuation and damages report considerations

What is an Intangible Asset?

- An intangible asset should be:
  - intangible; that is, it lacks physical substance, so its value comes from its bundle of legal rights
  - an asset; so it should have certain ownership characteristics:
    1. It is subject to a specific identification and a recognizable description
    2. It is subject to legal existence and legal protection
    3. It is subject to the rights of private ownership, and that private ownership should be transferable
    4. It is documented by some tangible evidence or manifestation of its existence (for example, a contract, a license, a registration document, a compact disc, a listing of customers, or a set of financial statements)
    5. It is created or comes into existence at an identifiable time or as the result of an identifiable event
    6. It is subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event

What is Not an Intangible Asset?

- There are intangible attributes or influences that may affect the value of intangible assets
- These attributes or influences are not assets
- Examples include:

1. High market share
2. High profitability or high profit margin
3. Lack of regulation
4. A regulated (or protected) position
5. Monopoly position (or barriers to entry)
6. Market potential
7. Breadth of customer appeal
8. Mystique
9. Heritage or longevity
10. Competitive edge
11. Life-cycle status
12. Uniqueness
13. Discount prices (or full prices)
14. Positive image
15. First to market
16. Technological superiority
17. Consumer confidence or trustworthiness
18. Creativity
19. High growth rate
20. High return on investment
21. Size
22. Synergies
23. Economies of scale
24. Efficiencies
25. Longevity

Examples of Intangible Assets: ASC 805

- Marketing-related intangible assets
  - Trademarks, trade names, service marks, collective marks, certification marks
  - Trade dress (unique color, shape, package design)
  - Newspaper mastheads
  - Internet domain names
  - Noncompetition agreements
- Customer-related intangible assets
  - Customer lists
  - Order or production backlog
  - Customer contracts and related customer relationships
  - Noncontractual customer relationships

Examples of Intangible Assets: ASC 805 (cont.)

- Artistic-related intangible assets
  - Plays, operas, and ballets
  - Books, magazines, newspapers, and other literary works
  - Musical works such as compositions, song lyrics, and advertising jingles
  - Pictures and photographs
  - Video and audiovisual material, including motion pictures or films, music videos, and television programs

Examples of Intangible Assets: ASC 805 (cont.)

- Contract-based intangible assets
  - Licensing, royalty, and standstill agreements
  - Advertising, construction, management, and service or supply contracts
  - Lease agreements (whether the acquiree is the lessee or the lessor)
  - Construction permits
  - Franchise agreements
  - Operating and broadcast rights
  - Servicing contracts such as mortgage servicing contracts
  - Employment contracts
  - Use rights such as drilling, water, air, timber cutting, and route authorities

Examples of Intangible Assets: ASC 805 (cont.)

- Technology-based intangible assets
  - Patented technology
  - Computer software and mask works
  - Unpatented technology
  - Databases, including title plants
  - Trade secrets, such as secret formulas, processes, and recipes

Examples of Intangible Assets: IRC 197

- Internal Revenue Code Section 197 intangible assets include:
  - Goodwill
  - Going concern value
  - Any of the following intangible items:
    - workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,
    - business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),
    - any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,
    - any customer-based intangible,
    - any supplier-based intangible, and
    - any other similar item.
  - Any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof

Examples of Intangible Assets: IRC 197 (cont.)

- Internal Revenue Code Section 197 intangible assets include: (cont.)
  - Any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not t o compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof
  - Any franchise, trademark, or trade name

Types of Intellectual Property

- There are four types of intellectual property
  - Patents
  - Trademarks
  - Copyrights
  - Trade secrets

Types of Intangible Asset Analyses

- Valuation
- Damages analysis
- Transfer price analysis
- Fairness opinion
- Solvency/insolvency analysis
- Private inurement opinion
- License royalty rate analysis
- Exchange ratio analysis

Categories of Reasons to Analyze Intangible Assets

- Transaction pricing and structuring
- Financing securitization and collateralization
- Federal and state tax planning and compliance
- Management information and strategic planning
- Bankruptcy and reorganization
- Forensic analysis and dispute resolution
- Intercompany use and ownership transfers
- Financial accounting and fair value reporting
- Corporate governance and regulatory compliance
- License, joint venture, development opportunities

Forensic Analysis Valuation and Damages Analyses

- Within a litigation context, most intangible asset valuations are performed for purposes of:
  - taxation disputes
  - shareholder disputes
  - family law disputes
- Within a litigation context, most intangible asset damages analyses are performed for purposes of:
  - breach of contract claims
  - tort claims

Intangible Asset
Breach of Contract Claims

- Employment agreements
- Noncompetition agreements
- Nonsolicitation agreements
- Advertising and other promotion agreements
- Product placement agreements
- Supply agreements
- Customer or client purchase contracts
- Loan indentures
- Leases
- Use licenses and other intellectual property licenses
- Franchise agreements
- Construction contracts
- Intellectual property commercialization or development agreements
- Joint venture agreements
- Procurement contracts
- Entire-output contracts
- Marine or other shipping contracts
- Take-or-pay contracts
- Marketing contracts
- Contracts to sell

Intangible Asset Tort Claims

- Examples of tort claims involving intangible assets include:
  - interference with business relationship
  - interference with business opportunity
  - interference with contractual rights
  - infringement
  - disparagement or defamation
  - fraudulent misrepresentation
  - condemnation and eminent domain
  - breach of fiduciary duty
  - breach of agency duty
  - lender liability

Intangible Asset Valuation or Damages – Bundles of Legal Rights

- Fee simple
- Term interest
- Life interest
- Residual/reversionary interest
- Licensor or franchisor interest
- Licensee or franchisee interest
- Sub-license or sub-franchisee rights
- Development rights
- Exploitation rights
- Commercialization rights
- Use rights – territorial/geographic
- Use rights – product/industry rights

Considerations Related to Bundles of Legal Rights

- Intangible asset/intellectual property type
- Term(s) of the transfer
- Territory of the transfer
- Products/services covered
- Ability to sublicense
- Ability to modify
- Exclusive/nonexclusive use
- Ability to assign
- Development responsibility
- Commercialization responsibility
- Maintenance responsibility
- Legal responsibility
- Registration responsibility
- Regulatory responsibility
- Minimum sales activity
- Minimum promotion activity

Intangible Asset Valuation Considerations

- What intangible asset is the valuation subject?
- What intangible asset rights are included in the valuation?
- What is the appropriate standard of value?
- What is the appropriate premise of value?
- What is the appropriate valuation date(s)?
- Who is the intended audience for the valuation?
- What is the appropriate type of report?

Generally Accepted Intangible Asset Valuation Approaches and Methods

- Cost approach methods
  - Reproduction cost new less depreciation method
  - Replacement cost new less depreciation method
  - Trended historical cost less depreciation method
- Market approach methods
  - Relief from royalty method
  - Comparable uncontrolled transactions method
  - Comparable profit margin method
- Income approach methods
  - Differential income (with/without) method
  - Incremental income method
  - Profit split method (or residual profit split method)
  - Residual (excess) income method)

Intangible Asset Cost Approach Valuation Components

- All cost approach methods include a current cost measurement and a depreciation measurement
- Four cost components
  - Direct costs (direct materials and direct labor)
  - Indirect costs (overhead and administrative expenses)
  - Developer's profit)on the direct and indirect costs)
  - Entrepreneurial incentive (opportunity cost—or lost income—during the replacement period)
- Three depreciation components
  - Physical depreciation (not a significant factor)
  - Functional/technological obsolescence (consider the intangible asset RUL)
  - Economic/external obsolescence (consider the intangible asset ROI)

Intangible Asset Cost Approach Valuation Components (cont.)

- Typical cost approach valuation formula

	Replacement cost new
less	Functional obsolescence
less	Technological obsolescence
less	Economic/external obsolescence
equals	Value

- Cost approach valuation considerations
  - All cost components (including opportunity cost) included in the measurement
  - Treatment of excess capital (development) costs and excess operating costs
  - Consideration of the intangible asset RUL
  - Consideration of owner/operator economic obsolescence

Intangible Asset Market Approach Valuation Components

- Valuation pricing metrics are based on either comparable or guideline:
  - licenses of intangible assets
  - sales of intangible assets
  - companies that use intangible assets
- Valuation variables and procedures
  - Quantitative/qualitative analysis of the subject intangible asset
  - Guideline license/sale/company selection criteria
  - Guideline license/sale/company selection
  - Verification of the selected transactional data
  - Analysis of the selected transactional data
  - Selection of the appropriate pricing metrics
  - Selection of the pricing multiples specific to the subject intangible asset
  - Application of the selected pricing multiples to the subject intangible asset metrics

Intangible Asset Market Approach Valuation Components (cont.)

- Market approach valuation considerations
  - Seasoned guideline intangible asset/development stage subject intangible asset
  - Development stage guideline intangible asset/seasoned subject intangible asset
  - State of the competition in the owner/operator industry
  - Comparable profit margins—is the subject intangible asset the only reason for the difference in profit margins between the owner/operator company and the selected CPM companies?:

Intangible Asset Income Approach Valuation Components

- Common intangible asset income concepts include:
  - incremental (or differential) owner/operator revenue
  - decremental owner/operator expense
  - decremental owner/operator investment
  - decremental risk to the owner/operator
- Common income measures (related to the subject intangible asset) include:
  - EBITDA
  - EBIT
  - NOI (EBITDA less income taxes)
  - Net income
  - Net cash flow

Intangible Asset Income Approach Valuation Components (cont.)

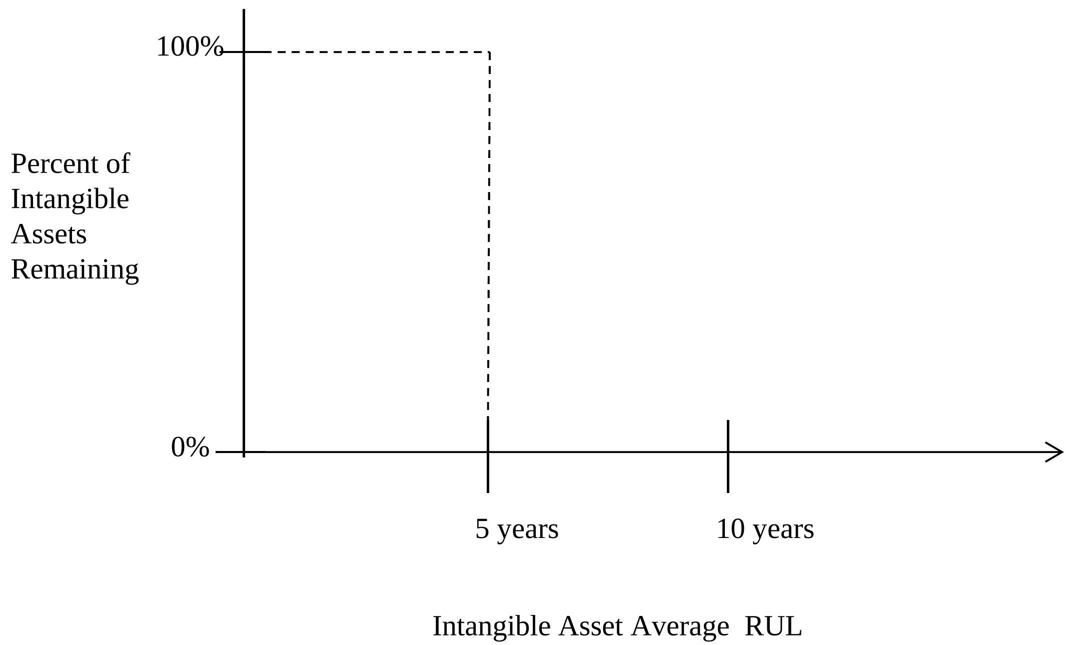
- Income approach valuation formula
  - Yield capitalization methods, based on a nonconstant growth income projection
    - over a finite RUL projection period
    - over a finite RUL projection period with a terminal value
  - Direct capitalization methods, based on a constant growth income projection
    - over a finite RUL projection period
    - over a perpetuity projection period

Intangible Asset Income Approach Valuation Components (cont.)

- Income approach valuation considerations
  - Match the selected discount/capitalization rate with the selected income measure
  - Match the selected discount/capitalization rate with the subject intangible asset risk
  - Consider the state of the competition in the owner/operator industry
  - Consider all subsequent (to the valuation date) capx, R&D expenses, marketing expenditures, etc.
  - Analyze only the income that is directly related to the subject intangible asset
  - Consider the applicability of the tax amortization benefit (TAB) adjustment
  - Present value the projected income over either:
    - the intangible asset average RUL
    - down the intangible asset RUL decay curve

Intangible Asset Income Approach Valuation Components (cont.)

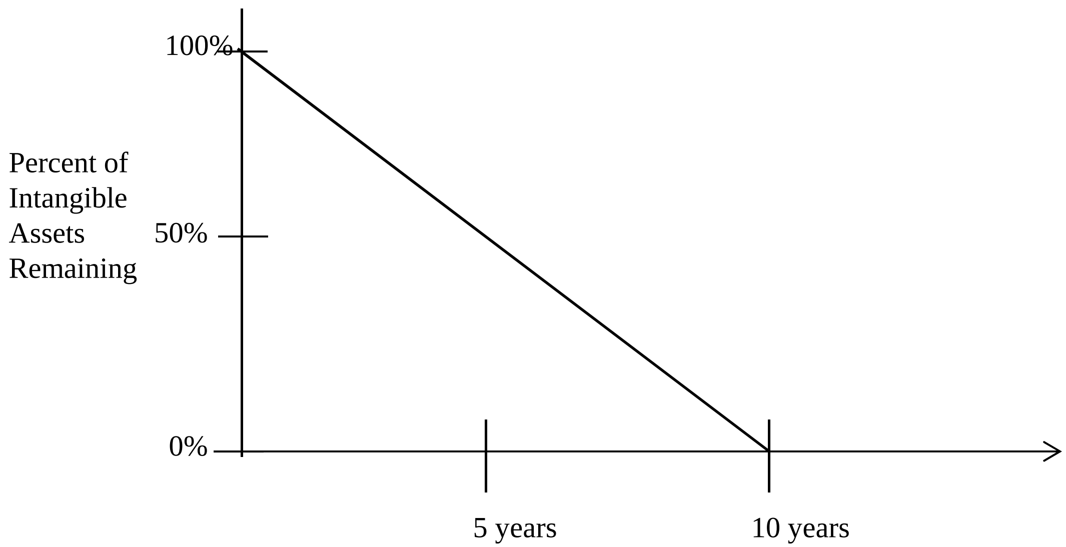
Illustrative Example
Present Value of Income Projection
Over the Intangible Asset Average Remaining Useful Life



Assume: Intangible Asset Total Remaining Life of 10 Years
Intangible Asset Average RUL of 5 Years

Intangible Asset Income Approach Valuation Components (cont.)

Illustrative Example
Present Value of Income Projection
Down the Intangible Asset Total Remaining Useful Life



Intangible Asset Total RUL

Assume: Intangible Asset Total Remaining Life of 10 Years
Intangible Asset Average RUL of 5 Years

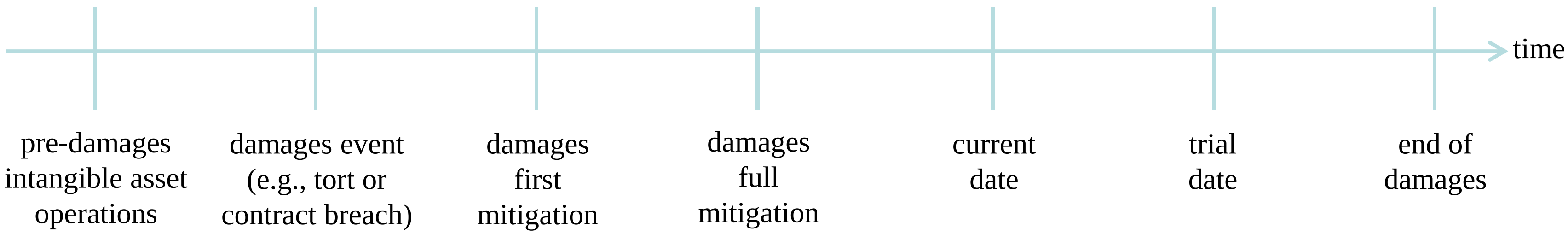
Intangible Asset Valuation Synthesis and Conclusion

- The synthesis and conclusion is the last procedure in the valuation process
- The analyst typically performs a valuation reconciliation procedure related to the alternative value indications
- The analyst answers the following questions:
  - Did I value the right thing? That is, did I analyze the correct intangible asset?
  - Did I value the right thing the right way? That is, did I apply the appropriate valuation approaches, methods, and procedures?
  - Did I reach the right value conclusion? That is, did I correctly apply the valuation procedures that I performed in order to reach a reasonable and supportable value estimate?
  - Did I do what I intended to do? That is, did I perform the assignment that I set out to perform? Did I achieve the purpose and objective of the assignment?

Intangible Asset Damages Considerations

- What is the intangible asset subject to damages?
- What are the intangible asset bundle of rights subject to damages?
- What is the damages event?
- What are the damages event dates/periods?
- What is the appropriate legal definition of the subject damages?
- Should I use any legally determined damages variables?
- Should I analyze mitigation?
- What should I assume about causation and liability?
- Are there any legally allowed or legally disallowed damages methods?
- Is the objective of the analysis to conclude:
  - the damages amount to the damaged party, or
  - the recommended judicial award to the damaged party?
  - In other words, should I consider the income tax impact of the judicial award to the damaged party?
- What is the appropriate type of report?
- Who is the intended audience for the damages analysis?

Intangible Asset Damages Analysis Dates



Generally Accepted Intangible Asset Damages Methods

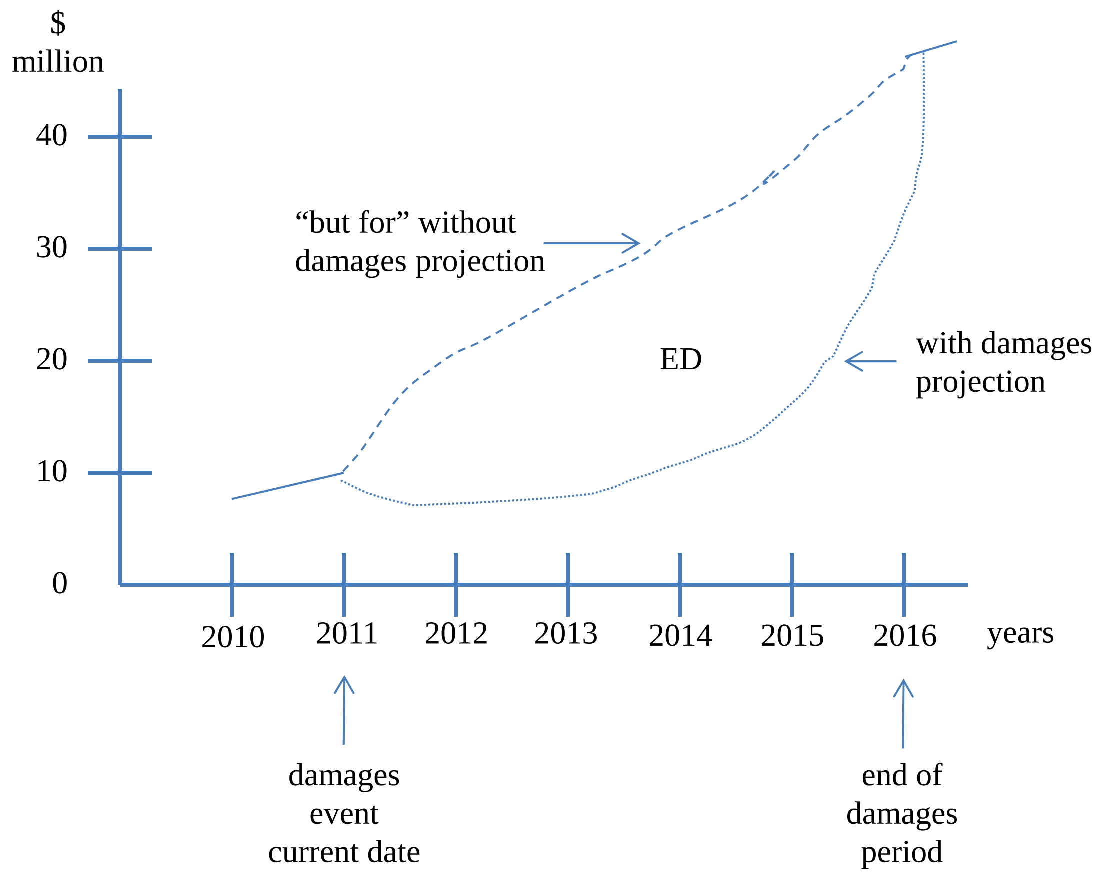
- The common intangible asset damages measurement methods include:
  - lost profits methods
  - lost value or cost to cure methods
  - reasonable royalty rate methods
- There may be other legally permitted damages measurement methods, such as:
  - unjust enrichment methods
  - statutory damages amounts

Lost Profits Damages Methods

- The three common lost profits damages measurement methods include:
  - The projections method
  - The yardstick method
  - The before and after method
- Lost profits measurement method considerations
  - What is the appropriate damages period?
  - What is the appropriate measure of income?
  - What is the appropriate present value discount rate?
  - Do I apply ex ante or ex poste damages measurement calculations?
  - Do I include lost profits on indirect or convoyed product sales?

Lost Profits Methods

Lost Profits Damages
Projections Method
Contribution Margin Measure of Profits



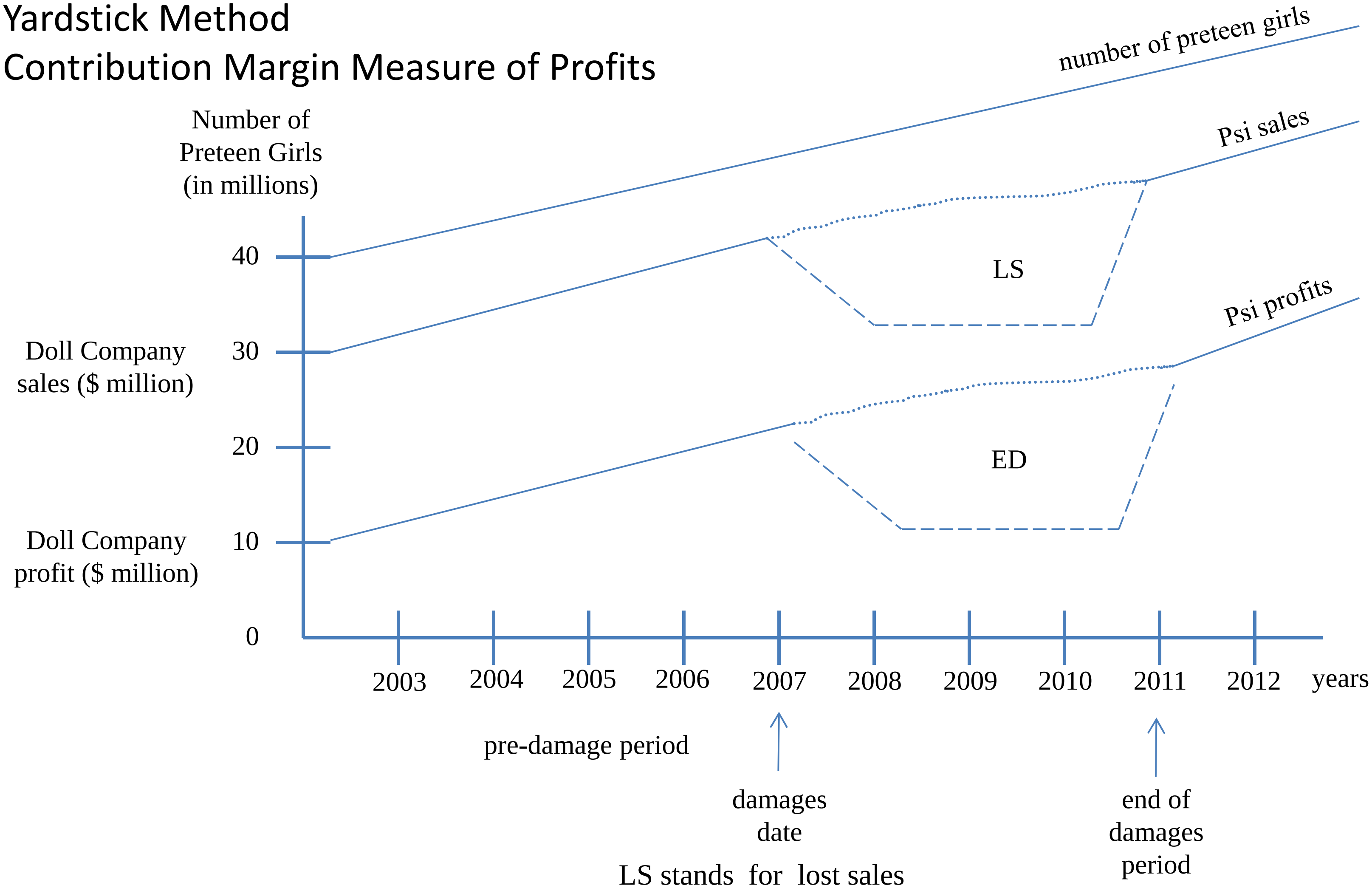
ED stands for economic damages

Lost Profits Methods

Lost Profits Damages

Yardstick Method

Contribution Margin Measure of Profits

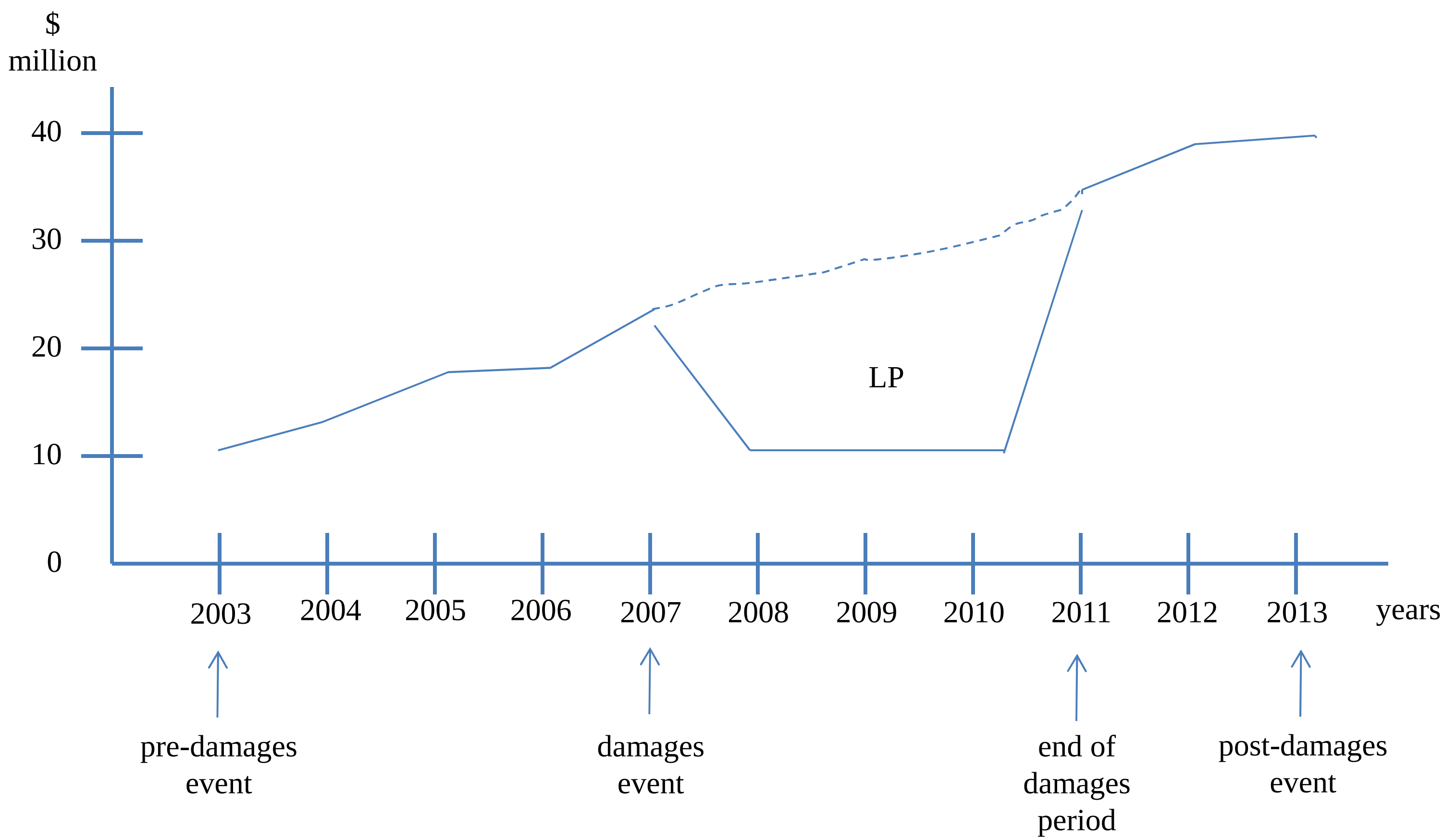


LS stands for lost sales

ED stands for economic damages

Lost Profits Methods

Lost Profits Damages
Before and After Method
Contribution Margin Measure of Profits



LP stands for lost profits

Lost Value or Cost to Cure Damages Methods

- Estimate the intangible asset value before the damages event versus the intangible asset value after the damages event
- Estimate the intangible asset value with the damages event versus without the damages event
- What is the appropriate standard of value to measure the cost to cure damages?
- The generally accepted intangible asset valuation approaches apply
  - cost approach
  - income approach
  - market approach

Reasonable Royalty Rate Damages Methods

- The four common intangible asset reasonable royalty rate estimation methods include:
  - The investment method
  - The income method
  - The comparable uncontrolled transaction method
  - The comparable profit margin method

The Damages Award as a Taxable Event

Recommended Judicial Award
Income Tax Adjustment to Actual Damages

Factor	Recommended Judicial Award Component		Amount
1.	Estimate of injured party intangible asset actual damages (based on any damages measurement method)		$10,000,000
2.	Estimate of income tax adjustment on the compensatory damages (1 – assumed 35% income tax rate)	+	65%
3.	Recommended total judicial award required to restore the claimant to its financial condition before the damages event		$15,385,000

Income Tax on Recommended Judicial Award
Reconciliation to Actual Damages

Factor	Actual Damages Reconciliation Component	Amount
1.	Assume the finder of fact orders the recommended total award (i.e., taxable income to the claimant)	$ 15,385,000
2.	Income tax expense related to the judicial award (at the 35% income tax rate)	5,385,000
3.	Reconciliation to injured party intangible asset actual damages	$ 10,000,000

Intangible Asset Valuation or Damages Report

- In order to encourage the reader's acceptance, the effective intangible asset valuation or damages report should be:
  - clear, convincing, and cogent
  - well-organized, well-written, and well-presented
  - free of grammar, punctuation, spelling, and mathematical errors
  - procedurally and mathematically replicable, without the use of any unexplained or unsourced valuation/damages variables

Intangible Asset Valuation or Damages Report (cont.)

- The persuasive intangible asset valuation or damages report will tell a narrative story that:
  - defines the analyst's assignment
  - describes the analyst's data gathering and due diligence procedures
  - justifies the analyst's selection of—and rejection of—(a) the generally accepted valuation approaches, methods, and procedures and (b) generally accepted damages measurement methods
  - explains how the analyst performed the valuation/damages synthesis and reached the final value/damages conclusion
  - defends the analyst's intangible asset value/damages conclusion
  - describes all of the data sources that the analyst relied on (and includes copies of nonpublic source documents)

Intangible Asset Valuation or Damages Report (cont.)

- Finally, do not ignore AICPA (or other relevant) professional standards:
  - SSVS for intangible asset valuations
  - SSCS for intangible asset damages analyses
  - there may be litigation-related reporting standards exceptions—but not valuation or damages analysis exceptions

Summary and Conclusion

- What are and what are not intangible assets
- Examples of intangible assets and intellectual property
- Types of intangible asset analyses
- Litigation and other reasons to analyze intangible assets
- Intangible asset valuation approaches and methods
- Intangible asset valuation considerations
- Intangible asset damages measurement methods
- Intangible asset damages considerations
- Valuation and damages report considerations
- Questions and discussion

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Robert Reilly has been a managing director of Willamette Management Associates for over 23 years. Willamette Management Associates provides business valuation, forensic analysis, and financial opinion services for transaction, financing, taxation, bankruptcy, litigation, and planning purposes. Robert frequently provides valuation, economic damages, and intercompany transfer price analyses related to intellectual property and other intangible assets. Robert has testified in both federal and state courts on numerous occasions on intellectual property valuation, damages, and transfer price matters.

Robert holds a BA in economics and an MBA in finance, both from Columbia University. He is a certified public accountant, accredited in business valuation, and certified in financial forensics. He is also a chartered financial analyst, chartered global management accountant, certified management accountant, certified business appraiser, and certified valuation analyst.

Robert has served as a member of the AICPA forensic and valuation services executive committee (FVSEC), business valuation committee (BVC), and consulting services executive committee (CSEC). He is an inductee into the AICPA business valuation hall of fame.

Robert is the co-author of 12 valuation books including *Guide to Intangible Asset Valuation* (published in 2013 by the AICPA) and *Practical Guide to Bankruptcy Valuation* (published in 2013 by the American Bankruptcy Institute).

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