Procedures Companies Can Use to Maximize the Value of Their Intellectual Property

Justin M. Nielsen and Robert F. Reilly, CPA

Valuation analysts can work with company senior management to more effectively use their intellectual property assets. The valuation analyst can document, inventory, and value all of the company's intellectual property. This discussion presents ten practical procedures that companies can use to benefit from the value of their intellectual property.

Introduction

The senior managements of most industrial and commercial companies make serious efforts to manage the company's working capital assets (e.g., marketable securities, accounts receivable, and inventory). And, the senior managements of such companies are conscientious about protecting the company's tangible assets (e.g., land, buildings, and equipment).

However, many corporate executives assign less importance to the management of their company's commercial intellectual property. Nonetheless, in many industries, intangible assets (including intellectual property) account for a large percentage of the typical company's total business enterprise value.

Intellectual property (IP) is a subset of general commercial intangible assets. Unlike other types of commercial intangible assets, IP assets enjoy special legal recognition and protection. There are four (and only four) types of IP: trademarks, patents, copyrights, and trade secrets.

A company's trademarks, patents, and copyrights are protected by federal statutes. A company's trade secrets are protected by state statutes. Most business entities own and operate at least some (if not all) of these four categories of IP.

In addition to owning IP, most commercial entities also own and operate a variety of general intangible assets. Other (non-IP) intangible assets may include operating licenses and permits, franchises and other contract rights, customer relationships, supplier relationships, computer software, engineering drawings and technical documentation, a trained and assembled workforce, and goodwill.

The typical business enterprise owns and operates IP such as product trademarks and company trade names, patents (and the related proprietary technology and designs), copyrights (including copyrights on advertising programs and materials, computer software, and product/process engineering drawings), and trade secrets (including proprietary product formulations, production processes, and operational systems and procedures).

Most business entities can benefit from more effective management of their IP. This more effective management can result from the improved internal control of, legal protection over, and economic commercialization of that company's IP.

Such IP management procedures can reduce the financial, legal, and operational risk of the subject company's business operations. And, such IP management procedures can also increase the value of the subject IP (and, therefore, the value of the subject business enterprise).

There are numerous procedures that a company can implement to more effectively manage its IP. This discussion summarizes ten procedures that the typical business entity can perform to more effectively control and more efficiently exploit its commercial IP. In particular, this discussion explains how the valuation analyst can help the IP owner/operator senior management to both (1) inventory, control, and appraise the company's IP and (2) maximize the value of the company's IP.

Role of the Valuation Analyst in the IP Management Process

Valuation analysts typically value commercial IP for various financial accounting, transaction, taxation, financing, licensing, regulatory compliance, corporate planning, bankruptcy, and litigation purposes. Economists, industry specialists, license executives, and other types of professionals also serve as IP valuation analysts. However, many IP owner/operators (and other interested parties) often retain certified public accountants (CPAs) as IP valuation specialists.

CPAs are often recognized as trusted advisers to business enterprise managers and owners. Many CPAs have earned a specialized valuation credential called the ABV, or accreditation in business valuation. This specialized valuation credential is granted by the American Institute of Certified Public Accountants (AICPA).

ABVs are CPAs who have pursued specialized training, testing, and credentialing in the valuation of businesses and intangible assets (including intellectual property).

Like CPA audit and tax specialists, these CPA valuation specialists comply with all of the AICPA comprehensive professional standards. In particular, CPAs comply with the authoritative AICPA Statement of Standards on Valuation Services (or SSVS), entitled *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*.

In addition to complying with SSVS and all of the other AICPA professional standards, CPA/ABVs apply generally accepted approaches, methods, and procedures to conclude the value, intercompany transfer price, arm's-length license royalty rate, or lost profits/economic damages related to commercial IP.

Valuation analysts typically work with the client company's financial engineering, IT, marketing, and corporate development executives to maximize the value of the company's IP. In addition, valuation analysts typically collaborate with the client company's general counsel during the IP analysis.

IP Valuation and Other IP Analyses

If the objective of the analysis is to estimate the value of the IP, the valuation analyst will apply generally accepted IP valuation approaches and methods.

For example, to value a particular company's IP, the valuation analyst may apply the following approaches and methods:

1. income approach methods (such as the capitalized excess earnings method or the profit split method);
2. market approach methods (such as the relief from royalty method or the comparable profit margin method), or
3. cost approach methods (such as the replacement cost new less depreciation method or the capitalized cost avoidance method).

For other types of IP analyses (e.g., intercompany arm's-length transfer price, third party license royalty rate, lost profits/economic damages, etc.), the valuation analyst will apply correspondingly specialized analytical approaches and methods.

In addition to the quantitative valuation analyses, the valuation analyst will perform due diligence procedures and apply qualitative analyses. For example, the valuation analyst may inventory, document, and organize all of the company's IP.

And, the valuation analyst may perform a competitive strategic analysis to assess the strengths, weaknesses, opportunities, and threats (SWOT) of the company's IP—compared to the industry competitors' IP. These due diligence procedures supply the subject company senior management with both quantitative and qualitative assessments that can be used in the effective management and exploitation of the subject IP.

Managing and Measuring the Value of the Commercial IP

To manage any type of asset (whether tangible or intangible), the business entity first has to identify, measure, and control that asset. Through the IP inventory, valuation, and centralization procedures, the valuation analyst helps the IP owner/operator senior management to both (1) understand the value of its IP and (2) increase the value of its IP.

The following discussion summarizes ten procedures that a company can implement in order to realize economic benefit from more effective IP management. These ten procedures are grouped into four common categories of IP management benefits.

Corporate Governance and Internal Control Benefits

1. An IP valuation may identify, inventory, and centralize the control of all of the company's commercial IP. At many companies, IP management is decentralized to the operating business unit (i.e., the plant, division, subsidiary, etc.) level.

   Such IP control centralization allows the company senior management to effectively perform its duties related to the internal control of all of the subject assets (such duties include, for example, compliance with the Sarbanes-Oxley Act).
2. An IP valuation may inform the company senior management as to the need for (and the appropriate amounts of) insurance on the commercial IP, including IP-related business interruption insurance and property insurance.
3. An IP valuation will help prepare the company for the expected near-term implementation of fair value accounting principles. After the convergence of US GAAP and IFRS and the associated US adoption of fair value accounting principles, a reporting entity may report the fair value of its intangible assets (including its IP).

Company Financing and IP Commercialization Benefits

4. An IP valuation allows the company senior management to identify (and pursue) previously unidentified IP commercialization opportunities. Such commercialization opportunities may include secured debt and equity offerings, inbound and outbound IP licenses, income tax reduction strategies, and other economic opportunities.

   For example, the company may use its IP value as the collateral for an asset-based debt financing. Or, the company may use its IP value to support its proposed stock valuation in the negotiation of an equity private placement.
5. An IP valuation may allow the company to generate incremental income from an outbound IP license to noncompetitive licensees. And, the company may conserve cash related to future IP development (a) by entering into inbound IP licenses from noncompetitive licensors or (b) by entering into IP joint development or joint commercialization agreements.

Legal Protection Benefits

6. Data from the IP inventory may allow the company's corporate counsel to:
   a. better protect all of the company's IP (including both inactive IP and defensive use IP),
   b. timely renew all of the IP registrations,
   c. monitor and review all IP licenses and agreements,
   d. implement or update all employee confidentiality and nondisclosure agreements, and
   e. perform other necessary tasks.
7. The IP valuation results may be used by the company's corporate counsel to prosecute a third party's infringement of the subject company IP. The inventory should document all of the IP ownership information. And, the IP valuation should provide relevant information that may be used by the company to support a claim for a reasonable royalty rate, lost profits, or other economic damages from the infringing party.
8. The IP valuation results may also be used by the company's corporate counsel to defend the company against IP infringement allegations by another IP owner.

   The IP analysis should document the IP development and the IP ownership, the legal registrations, and the history and description of the IP use. And, the IP valuation may indicate a reasonable royalty rate or other damages measures that the legal counsel may use to negotiate a settlement agreement with the damaged party.

Taxation Benefits

9. After the IP inventory and valuation process, companies may create an IP holding company and assign all of the current (and future) IP to that holding company. The IP holding company may be created in another state—or in another country—compared to the IP owner/operator.

   An IP holding company structure may allow the company to enter into intercompany IP license agreements with its operating business units. Depending on the taxing jurisdiction in which the IP holding company is created, such IP transfers and IP intercompany licenses may reduce state and federal income tax expense.
10. An IP valuation may be used by a corporate property owner to identify intangible assets that are typically excluded from state and local ad valorem property taxation. The company can then ensure that its property tax assessment does not include the value of its commercial IP.

    And, the IP valuation may be used to support federal income tax deductions, such as a tax deduction related to the charitable contribution of inactive IP to a university or other not-for-profit entity.

Summary and Conclusion

Most business entities own and operate commercial IP including trademarks, patents, copyrights, and trade secrets. However, many company senior management do not effectively manage their IP. Therefore, these companies do not generate all of the possible economic benefits associated with effective IP management.

A CPA/ABV valuation analyst has a unique combination of training, experience, and credentials related to intangible asset valuation and related analysis. And, the CPA/ABV valuation analyst complies with the AICPA professional practices and standards. Therefore, such a valuation analyst is eminently qualified to assist companies to recognize the value of their IP and to benefit from the commercial potential of their IP.

Using generally accepted approaches and methods, a valuation analyst can inventory and value the company's IP. This IP analysis allows the IP owner/operator to benefit from the improved internal control and legal protection of its IP. And, this IP analysis may allow the IP owner/operator to also realize economic benefits from IP-related transactions, financings, licenses, litigation, and tax deduction opportunities.

However, for most of these purposes, the IP owner/operator company is not the only (or even the primary) audience of the IP analysis. Rather, to achieve the intended corporate objectives, the IP owner/operator senior management may have to convince a banker, auditor, taxing agency, regulatory authority, licensee, joint venture, investor, judicial finder of fact, or other third party about the subject IP value.

In such instances, the objectivity and credibility of an independent valuation analyst may be particularly important in achieving the company's IP-related objectives.

Justin Nielsen is a manager in our Portland, Oregon, office. He can be reached at (503) 243-7515 or at jmnielsen@willamette.com.

Robert Reilly, CPA, is a managing director of the firm and is resident in our Chicago office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.