IPR for Finance Professionals

Rajesh Haldipur

Associate Director |Tax and Regulatory Services
PricewaterhouseCoopers Pvt Ltd
PwC House, 18/A, Guru Nanak Road
(Outside Bandra Rly Stn (West))
Bandra, Mumbai 400050.
D: +91-22-66891310 M: +91-9619451254
rajesh.haldipur@in.pwc.com

1 Important terms

1. Intangible Assets
   Long-lived assets without physical properties
2. Intellectual Capital
   Collection of long-lived Intangible Assets comprising "know-how" and "know-why".
   Subset of Intangible Assets
3. Intellectual Property
   Intangible Assets that enjoy Protection of Law.
   Subset of Intellectual Capital.
   - Patents (not discussed in this note)
   - Copyrights
     - Economic Rights
       - Reproduction Rights
       - Rights to distribute
       - Rights of Public Performance
       - Righs of Broadcasting/ Communication to Public
       - Rights of Translation and Adaptations
     - Moral Rights
       - Right to be recognised as Author/ Creator
       - Rights to Integrity of Work
     - Major Concepts
       - Life of Copyright
       - Concept of Fair Use
   - Trademarks
     - Can be Words, letters, abbreviations, drawings, 3D signs, packaging shape and design, colors / color combinations
       TM must be distinctive
       Must be Protected.
       Must not be deceptive
       Not be contrary to Public Order or Morality
       Not identical to or confusingly similar to existing trademark
       - Must be distinctive
     - Sign to identify goods
     - Includes Brands
     - Also, Collective Marks and Certification Marks
   - Trade Secrets
   - Others

        - Related Rights, for Protection of
            - Performers
            - Producers of Sound Recordings
            - Broadcasting Organisations
            - Fair use Doctrine applies
        - Service Marks
        - Industrial Designs
        - New Plant Varieties
            - Breeders' Rights protected
        - Protection against unfair competition
            - Protection against false allegations
            - Protection against acts that create confusion
            - Protection against acts that might mislead the public
            - Disclosure or use by others of secret/ confidential information
            - Acts that damage the goodwill or business reputation
        - Protection to genetically engineered bacteria etc.
        - Protection to Products of Traditional Knowledge
4. Freedom to Operate
   Ability to enter/ compete in a business/ segment.
   Others' IP tends to reduce it; own IP tends to expand it.

2 Why bother?

1. Because Intangibles are an increasing proportion of enterprise value (in some cases, as high as 80%)
2. Thus, intimately related to issues like share price, wealth creation & value realization
3. Because increasingly, IC/IP/IA are forming primary justification of even big-ticket acquisitions/ mergers
4. Because it is important to know, and inventorize IC owned by company as a First Step to realizing value
5. Costs of maintaining IP portfolios are becoming significant, hence there is need to focus on value

3 Important Aspects

1. **Valuation of IP**
    - ***Why conduct IP valuation?***
        - Objectives of Valuation
            - To estimate a value (as specifically defined) for particular IP
            - To measure lost profits or other measure of economic damages to IP
            - To estimate a fair license agreement royalty rate
              between independent arms' length parties
            - To conclude ALP for inter-company or cross-border transfer of IP
            - To estimate Remaining Useful Life of IP
            - To opine on fairness of IP sale, transfer or
              financing transaction from a financial perspective
        - Reasons to Conduct Valuation Exercise

- Transaction Pricing & Structuring
  - Arm's Length Sale of individual IP or of portfolio of IP Assets
  - Pricing Arm's Length License of individual IP or of portfolio of IP Assets
  - Calculating Exchange Ratio between 2 Owners for respective IP portfolios
  - Valuing Equity Allocations in JV/ Partnership when >=1 party contributes IP
  - Valuing Asset Distributions in Liquidation of Firm/JV when >=1 party receives IP Assets
- Financing Collateralization & Securitization
  - Using IP as Collateral in CF-based or asset-based debt financing
  - Sale/ License-back Financing of Commercial IP
- Tax Planning/ Compliance
  - Forming IP Holding Co; Inter-co. IP Licenses
    to assessee-operating companies
  - ALP for cross-border transactions (Transfer Pricing)
  - Tax basis purchase price allocation among
    acquired tangible & intangible assets in acquisition
  - Amortizing IP - tax deductions for
  - Donated IP - charitable contribution deduction allowances
- Regulatory Compliance & Corporate Governance
  - Estimating FMV of IP sale, license or other transfer
    between for-profit and not-for-profit entity
  - Custodial inventory of owned and licensed IP
  - Assessing adequacy of Insurance coverage for owned and licensed IP
- Bankruptcy & Reorganization
  - Using IP as collateral for secured creditor financing
  - Using IP as collateral for debtor-in-possession secured financing
  - Using IP in assessing debtor-co's solvency, or insolvency
    w.r.t. fraudulent transfers and preference actions
  - Estimating impact of IP on the bankrupt entity's re-organization plan
  - Evaluating opportunity to spin off Sale or Licensing of IP to generate cash
- Financial Accounting and Fair Value Reporting
  - Acquisition Purchase Accounting - allocation
    between acquired tangible & intangible assets
  - Goodwill and IPR impairment testing
  - Post-bankruptcy "fresh start" accounting for intangible assets
- Forensic Analysis and Dispute Resolution
  - Infringement claims - valuing lost IP profits, royalty rate or other economic damage analysis
  - Breach of contract/ license/ non-compete/ non-disclosure agreement damage
    claims - valuing lost IP profits, royalty rate or other economic damage analysis
- Strategic Planning and Management Information
  - Forming IP Joint Ventures, Joint Development,
    Joint Commercialization Agreements
  - Negotiating outward/ inward IP use, development,
    commercialization or exploitation agreements
  - Identifying & negotiating IP license, spin-off, JV
    or other commercialization opportunity

▪ Caveats

        - Objective determines valuation & drives approach - Never lose sight of it
        - Value in eyes of buyer may be completely different from value for seller
  - ***Generally Accepted Valuation Approaches***
    - Cost Approach
      - Reproduction cost new
        Total cost, at current prices, to develop an exact duplicate of the IP
      - Replacement cost new
        Total cost, at current prices, to develop an asset having same functionality/ utility as the IP. Roughly calculated as **Reproduction Cost New** *Less* **Curable Functional Obsolescence**.
      - Other cost approaches
        - Trended historical cost (inflation-indexed)
        - Cost avoidance attributable to IP
      - Cost in all cost approaches includes:
        - Direct Costs
        - Indirect Costs
        - IP developer's profit on investment in above two
        - Opportunity cost/ entrepreneurial incentive

          IP Value can be calculated as

          Replacement cost new
          Less **Physical Deterioration**
          Less **Economic Obsolescence**
          Less **Incurable Functional Obsolescence**
      - Cost needs to be adjusted for:
        - Physical deterioration
        - Functional obsolescence
        - Economic obsolescence (Remaining Useful Life)
    - Market Approach

      * Usually the first approach used, unless objective suggests another approach.
      * Market is considered to provide best indicator of value.
      - Comparable Uncontrolled Transaction (CUT)
        - Steps
        - Data Sources

          RoyaltySource (www.royaltysource.com)
          RoyaltyStat (www.royaltystat.com)
          Royalty Connection (www.royaltyconnection.com)
          ktMINE (www.bvmarketdata.com)
          Licensing Economics Review (monthly newsletter)
          License Royalty Rates (Aspen - book published annually)
          Royalty Rates for Trademarks & Copyrights (annually published book - Intellectual Property Research Associates)
          Royalty Rates for Pharmaceuticals & Biotechnology (annually published book - Intellectual Property Research Associates)
          Royalty Rates for Technology (annually published book - Intellectual Property Research Associates)
      - Comparable Profit Margin (CPM)
        - Steps
        - Data Sources

          for company profit margins:
          FactSet Research Systems - FactSet

Hoover's Company Records - Hoover's, Inc.
Morningstar Equity Research - Morningstar, Inc.
CapitalIQ - Standard & Poor's
Thomson ONE Analytics - Thomson Reuters
In India: Capitaline, Prowess

- Income Approach
  NPV of future income streams from owning/ operating IP.
  Three principal components:
    1. Estimate of **RUL (Remaining Useful Life)**
    2. Estimate IP-related income cash flows over RUL
    3. Estimate of appropriate Capitalization Rate (**Required Rate**)
  - Income Measures
    a. Gross/ Net Revenues
    b. Gross income (or profit)
    c. Net operating income
    d. Net PBT
    e. Net PAT
    f. Operating CF
    g. Net CF
    h. Incremental income
    i. Differential income
    j. Royalty income
    k. Excess earnings income etc.etc.
  - Methods that quantify/ estimate:
    1. Incremental level of IP income (commonly EBIT)
    2. Relief from hypothetical license royalty payment
    3. Residual measure of IP income
    4. Profit split between other assets and the IP
    5. Comparative income (usually EBIT)
       a. before and after IP development; or
       b. industry average income levels
       c. listed company income levels (called CPM)
  - Estimating RUL
    Usually affected by following considerations:
      1. Legal Factors
      2. Contractual Factors
      3. Functional Factors
      4. Technological Factors
      5. Economic Factors
      6. Analytical Factors

- Valuation "Synthesis" & Conclusions Procedures
  Must consider this following Question:
  - Does the selected approach accomplish the analyst's assignment?
  - Does it yield a
    * Defined Value
    * Transaction Price
    * 3rd party License Rate
    * Inter-co Transfer Price
    * Economic Damages Estimate
    * IP Bundle Exchange Ratio

* Opinion on fairness of Transaction Price
* etc. etc.

5. Accounting and Reporting of IPR
   - Standards & Pronouncements
     - Indian
       - Old AS 8 (Accounting for R&D)
       - AS 26 (part of broader bucket called Intangible Assets)
         - Acquisition cost becomes value of IPR if ...

           Generally comprises:
           amounts expended by original developer
           + negotiated premium which is NPV of expected future profits of new owner
           - 3 conditions satisfied: identifiability of asset, future economic benefits and reliably measurable cost
         - Accounting rules depend on stage
           - In research phase, all expenses fully written off
           - In development phase
             - Recognize as asset if
               - Asset can be developed into saleable product
               - Co intends to sell/ use the product
               - Co has ability to sell the product
               - Expected benefits can be measured reliably
             - Else, expense fully
         - Amortize depreciable amount over best estimate of RUL, which should not be >10 years fromd ate asset available for use. Amortization charge to be expensed in each period
         - Residual value at end of RUL should be 0 unless it has active market at end of useful life or a third party has committed to buy it after the period
         - If asset acquired legally, then RUL can exceed legal limit if legal right is renewable
         - Amortization period and method to be reviewed every year, and changed if required
         - Profit/Loss on dsposal of an IA to be disclosed as Income or Expense in P/L A/c
         - Disclosures
           - for each class of IAs
           - distinguished between internally developed and other IAs
           - Useful lives or amortization rates used
           - Amortization methods used
           - Gross carrying amount and accumulated (amortization+impairment charges)
           - Reconciliation of opening and closing carrying amount

             Showing
             additions from internal development/ amalgamation
             retirements and disposals
             impairment losses reversed if any

amortization recognized during period
other changes in carrying amount during period

- If IA amortized over >10 years, reason for same
- Description, carrying amount and amortization of any IA that is material to enterprise as a whole
- R&D expenditure recognized during the year

- IAS/IFRS
  - Old SSAP 22: Accounting for Goodwill
  - IAS 38
    - Acquisition cost becomes value of IPR if ...

      Generally comprises
      amounts expended by original developer
      + negotiated premium which is NPV of expected future profits of new owner
      - 3 conditions satisfied: identifiability of asset, future economic benefits and reliably measurable cost
    - Value of IPR is either ...
      - Historical cost *less* amortisation or impairment losses
      - Fair value *less* amortisation or impairment losses
- US GAAP
  - FAS 142
    - Intangible assets acquired individually or in a group to be accounted for on acquisition
    - Cost of developing, maintaining and restoring intangible assets not specifically identifiable to be recognized as revenue expenses when incurred
    - Amortize over best estimate of RUL, not exceeding 20 years from date asset available for use
    - If RUL is >20 years, apply IAS 36 (Impairment test) every year and explain why asset has life >20 years
  - FAS 86
    - Self-developed sofware intended to be leased out

- Laws relating to IPR
  - Patents
  - Copyrights
  - Trademarks
  - Industrial Designs
- Treatment
  - If Self-developed
    - Recognized as asset if ...
      - 3 conditions satisfied: identifiability of asset, future economic benefits and reliably measurable cost
    - Value of IPR
      - If R&D project is infructuous, (ie, no IPR results) write off 100%
      - If R&D leads to creation of IPR, (NPV of expected profit stream from sales attributable to IPR + costs of patent search and filing) taken as value

        - If Acquired
            - Pronouncements in respective jurisdictions determines accounting and reporting
            - Pronouncements generally deal with
              conditions for recognition of an intangible as an asset; and
              at what value to be recognized
    - IP Valuation must follow doctrines of
        - Conservatism
        - Materiality
        - Consistency