Intellectual Property Valuation Considerations Specific to Fair Value Measurement Assignments

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Fair value measurements are rules-based analyses. Fair market value valuations are judgment-based analyses. This discussion focuses on the fair value measurement of intellectual property for various purposes related to U.S. generally accepted accounting principles ("GAAP"). In particular, this discussion considers the application of the cost approach in the development of intellectual property fair value measurements prepared in order to comply with various GAAP financial accounting provisions.

Introduction

This *Insights* issue does not focus primarily on intellectual property valuations prepared for fair value measurement ("FVM") financial accounting purposes. Such FVM analyses are developed based on the fair value standard of value.

This discussion, however, summarizes many of the analyst considerations related to intellectual property fair value measurements developed for financial accounting purposes.

Fair Value Measurements

Typical FVM assignments involving intellectual property include the following:

1. The intellectual property FVM developed in the context of the acquisition accounting for a business combination (in compliance with Financial Accounting Standards Board ["FASB"] Accounting Standards Codification ["ASC"] Topic 805)
2. The intellectual property FVM developed in the context of testing for intangible asset impairment and goodwill impairment (in compliance with FASB ASC topic 350)

The FVM of private equity or venture capital fund portfolio investments may also involve analysis of the intellectual property developed and owned by the portfolio company. Such an intellectual property analysis may be included in a valuation analysis of the portfolio company that applies the asset-based approach and the asset accumulation method of business valuation.

Each of the above-mentioned assignments typically involves the FVM of intellectual property as a component of the financial accounting analysis.

Acquisition accounting FVM assignments are developed after a business combination transaction. With few exceptions, FASB ASC 805 business combination provisions require the FVM of the acquired assets and the assumed liabilities—to be recognized at acquisition date.

Related to post-acquisition accounting, the impairment testing of the carrying amount of an owner/operator's intangible assets (including the intellectual property) is typically developed on an annual basis.

Under U.S. generally accepted accounting principles ("GAAP"), the guidance for the impairment testing of indefinite-lived intangible assets and goodwill is provided in FASB ASC Topic 350.

Both purchase accounting FVM and indefinite-lived intangible asset or goodwill impairment testing assignments involve the fair value standard of value —as provided for in the FASB ASC Topic 820, *Fair Value Measurements* guidance.

FASB ASC Topic 820-10-20 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Accordingly, the fair value standard of value will often differ from other standards of value. The FVM should reflect all assumptions that market participants would use in pricing an asset or a liability. The FVM does not necessarily reflect the specific reality or assumptions of the actual intellectual property owner/operator or of a particular intellectual property willing buyer/seller or willing licenser/licensee.

When developing an FVM for a financial accounting assignment, there are often additional procedures that the analyst should consider in order to develop the perspective of a market participant.

The following list provides some FVM-specific procedures that the analyst may undertake when developing an intellectual property FVM for financial accounting purposes:

- Select the appropriate market for the intellectual property.
- Identify the market participants.
- Apply market participant assumptions.
- Determine the highest and best use ("HABU") for the intellectual property.

Because the definition of fair value is an exit price that uses market participant assumptions, the intellectual property's actual intended use by its actual owner/operator is rarely considered relevant for purposes of FVM under FASB ASC Topic 820.

Typically, the analyst begins with the actual circumstances or assumptions that may be applicable to the subject intellectual property owner/operator. The analyst then performs procedures to assess whether evidence exists that market participants would make different assumptions.

In addition, in accounting for the perspective of a market participant, the analyst may analyze and quantify certain components of a cost approach valuation analysis differently in an FVM assignment.

For example, an analyst developing an FVM should consider whether a market participant would be willing to pay for the developer's profit or the entrepreneurial incentive components of the cost approach valuation analysis.

When developing an FVM in accordance with FASB ASC Topic 820, it is important for analysts to comply with this guidance (and with any other applicable FASB ASC topic). Accordingly, analysts should refer to the relevant FASB guidance when developing an FVM for financial accounting purposes.

FASB ASC Topic 820, *Fair Value Measurement* establishes specific guidance for FVM reporting. While such guidance is generally formulaic, it also allows for some professional judgment. In circumstances that require professional judgment, it is possible for two analysts—given the same facts and circumstances—to arrive at different value conclusions that result in different financial reporting for the intellectual property owner/operator.

For example, the analyst's treatment of the income tax amortization benefit ("TAB") adjustment exemplifies a circumstance (1) that requires professional judgment and (2) that may produce different financial reporting outcomes. However, relevant FASB ASC guidance should be adhered to when preparing and documenting the processes and procedures performed in developing an FVM—even when analyst professional judgment is applied.

The Mandatory Performance Framework

Analysts should be aware of all recent developments related to FVMs and to financial accounting assignments. Some of these developments include:

1. the Certified in Entity and Intangible Valuations ("CEIV") credential and
2. the publication of the *Mandatory Performance Framework* ("MPF"), developed by the Performance Framework Task Force.

The CEIV credential is offered by several valuation professional organizations ("VPOs"). These VPOs include the American Institute of Certified Public Accountants, the American Society of Appraisers, and the Royal Institute of Chartered Surveyors.

The CEIV credential was developed specifically to address FVMs performed for financial accounting purposes. An important consequence of the development of the CEIV credential is the implementation of the MPF.

The MPF is defined in the *Mandatory Performance Framework for the Certified in Entity and Intangible Valuations Credential* as "a document for valuation professionals that provides guidance on how much support, in terms of scope of work and documentation, should be prepared or obtained when designing, implementing, and conducting valuations of businesses, business interests, intangible assets, certain liabilities, and inventory used for management assertions made in financial statements issued for financial reporting purposes."

Only CEIV credential holders are required to comply with the provisions of the MPF. For valuation analysts who do not hold the CEIV credential, however, the consensus of the valuation profession is that the MPF (1) represents best practices and (2) provides instructional guidance and parameters that will improve the quality of documentation and work related to FVMs and other financial accounting valuation assignments.

This MPF professional guidance specifically relates to:

1. due diligence procedures and
2. valuation work paper documentation and analysis support.

The MPF document includes the following four sections:

1. *Preamble*. This MPF section provides an overview of the framework's scope and purpose.
2. *Valuation engagement guidance*. This MPF section establishes the parameters of documentation requirements that valuation professionals should adhere to.

3. *Mandatory performance framework glossary.* This MPF section sets forth the definitions of terms that may be unique to the framework and, when necessary, defines their meaning within the context of the MPF.
4. *Authoritative and technical guidance.* This MPF section lists accounting, auditing, and valuation standards and certain technical literature applicable to the MPF guidance.

In addition, as a separate document, the *Application of the Mandatory Performance Framework for the Certified in Entity and Intangible Valuations Credential* (the "Application"), provides professional guidance related to applying the MPF to specific subject matter interests.

Both the MPF and the Application emphasize intellectual property valuation procedures that relate to the market approach and the income approach within the context of the fair value standard for FVM purposes.

The MPF and the Application also provide relevant guidance concerning the application of the cost approach to intellectual property FVM purposes.

Among other topics, the MPF includes professional guidance related to the following topics:

- The application and measurement of the TAB
- The derivation of a present value discount rate
- The application of valuation discounts and premiums
- The estimation of useful economic life ("UEL")
- The valuation of the assembled workforce as a contributory intangible asset
- The reconciliation of intellectual property value indications when several valuation approaches are applied

Beyond providing guidance regarding the factors for an analyst to consider when developing intellectual property FVMs, the MPF describes minimum scope of work and due diligence procedures. The analyst should apply the procedures described in the MPF guidance when selecting and applying the cost approach.

Whether the analyst holds the CEIV credential and is required to adhere to the MPF or the analyst is not a CEIV credential holder but is applying the MPF to follow the profession's best practices, the MPF provides guidance on how much work to do for the valuation, not how to develop the valuation.

The analyst's professional judgment is important to ensure that relevant inputs, procedures, and assumptions are applied to each FVM engagement. The MPF provides professional guidance to assist the analyst to develop an FVM that is transparent and auditable.

Summary and Conclusion

A fair value measurement is a rules-based analysis. A fair market value valuation is a judgment-based analysis. This discussion considered (1) the GAAP accounting guidance and (2) the other professional guidance related to the fair value measurement of intellectual property.

In particular, this discussion considered the application of the cost approach in a fair value measurement developed for various financial accounting purposes.

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