ACCOUNTING TREATMENT AND VALUATION ISSUES IN INTELLECTUAL PROPERTY

LIVE CHAT: QUESTIONS AND ANSWERS

INTRODUCTION

This live chat addressed questions following on from two recent intellectual property recordings - one on valuation methodologies and the other on implications of the accounting treatment of intellectual property.

Valuation of Intellectual Property

The Valuation of Intellectual Property recording discusses the definition of intellectual property; the purpose of valuation; the stages of intellectual property development; and the range of valuation methodologies commonly used to value intellectual property, including relief from royalties, excess profits, gross profit differential, premium sales price, comparable analysis, historical cost, replacement cost and enterprise approach.

Accounting Treatment of Intellectual Property

The Accounting Treatment of Intellectual Property recording examines the implications of the accounting treatment of intellectual property under AASB 138, including implications of the treatment of IP for internal business planning or analysis and external valuation purposes. The narrow historical genesis in the accounting for research and development under IAS 38 has left the accounting for IP without a relevant and logical framework and businesses need to build a business plan to communicate their value proposition.

The experts who addressed members' questions were:

- Professor Anne Wyatt, UQ Business School
- Mark Whittaker, Partner, Corporate Finance, BDO Brisbane.

This live chat is part of a series presented in association with IP Australia.

RESOURCES

Access the full range of complimentary IP recordings and fact sheets at http://www.cpaaustralia.com.au/intellectualproperty

QUESTIONS AND ANSWERS

What valuation methodology would you use for mature company's IP?

Discounted cash flow.

What can businesses do to communicate IP value to investors?

Central to strategy is an upfront business plan.

How soon should any IP or trade mark be valued? That is at inception and then how regularly.

There is no hard and fast rule and really depends on the reason for the valuation. The sooner the valuation is completed the more likely there is for the information to be current. For example, for financial reporting purposes you will need to consider for likelihood of impairment at each reporting period. If you are considering succession planning or some other type of transaction then it may assist to regularly get an IP value to understand what drives the value.

The question of when to value is particularly important when raising capital and undertaking purchase and sale transactions. A deeper and more fundamental consideration is that the genesis of all of a business's IP, its development or purchase, and use and licensing etc., all needs to be pre-planned. A business plan detailing financing, legal protection, how value will be generated by the IP, use of cost systems to carefully track all expenditures, all needs to be taken into consideration on a continuing basis. All of this information will then be available when valuation is needed.

Can you recommend a good book on the valuation of IP?

Not specifically in relation to IP valuation although there is more general valuation books that may assist. For example, the Cost of Capital by Shannon Pratt and Roger Grabowski if you want to understand discount rates more generally. There is also a lot of good publicly available information, including the Intellectual Property section on the CPA website.

If IP has no current trade figures attached to it, how would you value the value perceived by the prospective purchaser? Is there a methodology normally used by the purchaser or does the vendor just bargain for the best outcome?

Ultimately the purchaser is going to be interested in the return they make on their investment through the cash flows. For a business in earlier stage with no cash flow, the cost to develop can often be a good guide. One way may be to discuss the costs with the potential purchaser and then allow for a return on your time to assist support a value. Obviously the purchaser will also want to understand future potential of the IP for this methodology but approach above may assist around some of the subjectivity prior to sustainable cash flows being generated.

In valuing start up IP, is it best just to record at cost within the balance sheet?

AASB138 has very strict rules about the recognition of intangible assets on the balance sheet. The over-riding intention of this accounting standard is to only include externally purchased or contributed IP on the balance sheet. I would suggest that at the time of a start-up it is important to communicate the existence of the IP to capital providers and customers and other interested stakeholders via the balance sheet if the strict rules in the standard are met. However, it is very important that the business owner is clear that more than more recognition on the balance sheet is needed to be informative. Further, and even more important - behind the scenes the business owner needs a clear strategy as to how value is going to be leveraged from the IP. If not then value may not be generated and meet the promise sitting in the balance sheet IP asset.

How would you value a master franchise and are there any references that I can use to read up on this?

A master franchise would be valued having regard to the future cash flows expected to be generated. Matters to consider include where are stores going to be opened and how much cash would be generated from each store. You would also need to factor into the discount rate the risk associated with the cash flows. A master franchise for established businesses is going to be less risky than master franchise that is at the beginning of a growth phase with significant ramp-up expected.

I am not aware of any references off the top of my head, sorry.

Is the valuation of IP purely a quantitative calculation or do you take qualitative factors into consideration?

The role of IP in a business is to contribute to the ability of the company to compete and produce. IP assets are all unique - that is that are not standardised assets. Taking these elements into account, IP can only be valued by thinking through the nature of the rights embedded in the IP and how those rights can be employed in the business to generate value. Only once the qualitative aspect of the value creation process associated with the IP are worked through, can any quantitative element come into play in forecasting cash flows and earnings.

Ultimately for IP to be of value there needs to be cash flows that will derived by the owner. This is a quantitative calculation.

Notwithstanding, the development of the cash flows and appropriate discount rate will involve considering all relevant information including qualitative information.

Is the concept of excluding special or synergistic value important? Is this possible where the IP is only of value to a limited number of say established manufacturers?

The concept of understanding synergistic value is important. If the most likely purchaser for an asset is, say, one of the limited number of established manufacturers, then it may be very relevant to include in your valuation. If it is uncertain that potential purchaser will derive the synergies then unlikely to include in base value. However, it is still worth understanding as final acquirer may be able to derive the synergies and you may be able to negotiate a payment for some or all of the synergies.

This source of value is very important for a business (or potential acquirer) to understand preparatory to leveraging the expected value creation. This type of value is specific to individual transactions and IP. In fact, combining a range of resources to generate value in a unique way is what generates competitive advantage and guidance towards sustainable earnings. As an accounting aside, this type of value is viewed as goodwill by the accounting standards and will only ever appear on a balance sheet as purchased goodwill when one company purchases another company or functioning business.

When it comes to accounting for IP, there is a potential 'double counting' issue if an IP valuation around synergy is essentially booked to the balance sheet because that value will eventually come back to the company (assuming the company is able to realise the expected value) through cash flows.

CONCLUSION

As a side issue, there are lots of interesting questions about valuing single or groups of IP rights coming through today. Another related factor to think about is the role of IP valuations in the valuation of a company. In fact, one does not need to value IP and recognise it on the balance sheet to obtain a good valuation of a company. Of course, knowing everything a business can about its IP is critical. But if the goal is to value the company, then valuations of intangibles tend to add significant error to equity and whole of company valuations. One can obtain a good valuation for intangibles rich companies by computing reasonable forecasts of income statement and key balance sheet items from a comprehensive forecasting, and then use the residual income valuation model and build in the forecasts and growth rates in residual income. Once again, this point does not negate the critical importance of planning and management of IP and knowing what the business will do to obtain value from the IP - e.g. exercise market power, sell the IP, license the IP, collaborate in strategic alliances with the IP etc.

FURTHER INFORMATION

W: http://www.cpaaustralia.com.au/intellectualproperty

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ABOUT THE PRESENTERS

Professor Anne Wyatt (UQ Business School) has a PhD from University of Technology Sydney focused on accounting for investments in intangible assets, is a Chartered Accountant, and a graduate member of the Australia Institute of Company Directors. Professor Wyatt has an international reputation for excellence in professional and academic research and scholarship arenas.

Mark Whittaker (Partner, Corporate Finance, BDO Brisbane) specialises in valuations, independent expert report preparation, financial modelling, mergers and acquisitions and corporate advisory. Mark is both a member of Chartered Accountants Australia & New Zealand and a Chartered Financial Analyst ® (CFA) Charterholder.