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Financial Crime Compliance:

A Brief Guide for Senior Bank Management, Compliance Officers and Internal Auditors

Also in this issue

The Value and Management of Intellectual Property, Intangible Assets and Goodwill

When a company buys another company, how does it value its brands? When an investor is assessing the value of a technology business how does it value its assets? What's a biotech asset worth? In this article valuations expert Kelvin King takes GRU readers through the legal and accounting principles that govern the valuation of intellectual property rights, intangible assets and goodwill, a crucial problem for legal, accounting, banking and venture capital professionals and the owners and managers of IP assets.

Intellectual capital is recognised as the most important asset of many of the world's largest and most powerful companies; it is the foundation for the market dominance and continuing profitability of leading corporations. It is often the key objective in mergers and acquisitions and knowledgeable companies are increasingly using licensing routes to transfer these assets to low tax jurisdictions. Accounting Standards have traditionally not been helpful in representing the worth of intellectual property rights and intangible assets (IPR) in company accounts.

Future winners will be those who own and effectively manage intellectual capital which, an asset such as a brand, patent portfolio, etc. has become possibly the most critical success factor. No sector has been untouched by IPR.

It is impossible to 'manage' without having some understanding of value and the benefits of good IPR management. Critical issues include:

- Increased returns on capital invested in the business, particularly capital tied up in intellectual property
- Increased shareholder value
- A thorough understanding of the alignment of intellectual property development or acquisitions and business strategic objectives
- The ability to make informed decisions about intellectual property development or acquisition
- The creation of new and diverse revenue streams from intellectual capital and especially from underused intellectual capital
- The ability to know the valuable intellectual capital (perhaps within a large portfolio) and so protect it fully, and the intellectual capital of no significant value which, might be sold or abandoned
- Achieving lower overall costs associated with intellectual capital development or acquisition, protection, and utilisation
- Creating internal awareness of the importance of intellectual capital to success

It is fair to say that the role of IPR in business is often insufficiently understood. It may be under-valued, under-managed or under-exploited and enjoying little co-ordination between the different professionals dealing with an organisation's IPR. It is often commonly perceived as the domain of the legal profession, costly and difficult to easily and readily access when required. Whether part of a C-Suite, an accountant, a corporate finance professional, investor or a venture capitalist a thorough understanding of intellectual capital especially IPR is required to do your job better. IPR are both important and complex.

A good start is by asking the following questions:

- What are the IPRs used in the business?
- What is the value (and hence level of risk)?
- Who owns it (could we sue or could someone sue us)?
- How may it be better exploited (e.g. licensing in or out of technology)?
- At what level do we need to insure the IPR risk?

Legal and Accounting Issues Impacting IPR Valuation

The current big five issues for IPR valuation include Accounting Standards, Corporate Governance, Litigation (Defence and Attack), Fairness Opinions and in -process Research and Development.
Let us review the first two here:

Accounting Standards

IFRS 3 business combination valuation allocations, IAS 38 recognition of IPR in accounts and IAS 36 valuation impairment tests

Purchase accounting must be applied to all acquisitions (business combinations are also treated as acquisitions, and there is no more merger accounting). Many intangible assets that would previously have been subsumed within goodwill must be separately identified and valued. Explicit guidance is provided for the recognition of such intangible assets and IFRS3 includes a list of assets that are expected to be recognised separately from goodwill.

The valuation of such assets is a complex process and nearly always require specialist IP valuation skills and frequently an IP lawyer to undertake the categorisation the valuer requires. Examples of intangible assets to be separately recognised and categorised within the purchase cost are set out in the regulations and include those marketing related (trademarks, brands, domain names, newspaper masterheads): customer related (customer lists and contracts): artistic related (television programmes, photographs, films, publications): contract basis (e.g. licensing and royalty agreements, contracts for numerous situations such as advertising, construction and supply): technology based (patents, computer software, databases, trade secrets etc.).

Additionally under IAS 36 valuations need to be independently tested for impairment by the valuer on a regular basis. Obviously one of the valuers first questions will be, with advice from the IP lawyer, patent or trademark attorney; has there been any diminution of the legal nature of the originally categorised IP.

Corporate Governance

There is developing statute and case law which will compel boards of directors to accept that they must undertake and lead IP decisions rather than leave them to management.

- Sarbanes – Oxley. The provision of valuation services for audit clients is prohibited.

- Caremark International Inc. 1996 imposed on directors the duty to ensure adequate reporting.

- A Walt Disney case in 2003 and Research in Motion (the Blackberry case) establish the potential liability of directors in respect of IP.

The Valuation Expert

For the valuer, this process of understanding is not usually a problem when these rights have been formally protected through trademarks, patents or copyright. This is not the case with intangibles such as know how, (which can include the talents, skill and knowledge of the workforce), training systems and methods, designs, technical processes, customer lists, distribution networks etc. These assets are equally valuable but more difficult to identify in terms of the earnings and profits they generate. With many intangibles a very careful initial due-diligence process needs to be undertaken together with IP lawyers and in-house accountants.

Overall risk affects valuation analysis, corporate valuation must reflect risk and most importantly risk assessment should reflect IPR value.

One of the key factors affecting a company's success or failure is the degree to which it effectively exploits intellectual capital and values risk. Management obviously need to know the value of the IPR and those risks for the same reason that they need to know the underlying value of their tangible assets; because business managers need to know, or should know, the value of all assets and liabilities under their stewardship and control, to make sure that values are maintained. Markets (restricted or otherwise), institutions and shareholders need to be educated. Exploitation can take many forms, ranging from outright sale of an asset, a joint venture or a licensing agreement. Inevitably, exploitation increases the risk assessment.

The Valuation Procedure

Valuation procedure is, essentially, a bringing together of the economic concept of value and the legal concept of property. The presence of an asset is a function of its ability to generate a return and the discount rate applied to that return. The cardinal rule of commercial valuation is: the value of something cannot be stated in the abstract; all that can be stated is the value of a thing in a particular place, at a particular time, in particular circumstances. The questions 'to whom?' and 'for what purpose?' must always be asked before a valuation can be carried out. This rule is particularly significant as far as the valuation of intellectual property rights is concerned. More often than not, there will only be one or two interested parties, and the value to each of them will depend upon their circumstances. Failure to take these circumstances and those of the owner, into account will result in a meaningless valuation.

Value Concepts

There are four main value concepts, namely, owner value, market value, tax value and fair value. Owner value often determines the price in negotiated deals and is often led by a proprietor's view of value if he were deprived of the property. The basis of market value is the assumption that if comparable property has fetched a certain price, then the subject property will realise a price something near to it. The fair value concept, in its essence, is the desire to be equitable to both parties. It recognises that the transaction is not in the open market and that vendor and purchaser have been brought together in a legally binding manner. Tax valuation has been the subject of case law worldwide since the turn of the century and is an esoteric practice. There are quasi-concepts of value which impinge upon each of these main areas, namely, investment value, liquidation value, and going concern value.

Methods for the Valuation of IPR

Acceptable methods of the valuation of identifiable intangible assets and intellectual property fall into three broad categories. They are either market based, cost based, or based on estimates of future economic benefits. In an ideal situation, an independent expert will always prefer to determine a market value by reference to comparable market transactions. This is difficult enough when valuing assets such as bricks and mortar because it is never possible to find a transaction that is exactly comparable. In valuing an item of intellectual property, the search for a comparable market transaction becomes almost futile. This is not only due to lack of compatibility, but also because intellectual property is generally not developed to be sold and many sales are usually only a small part of a larger transaction and details are kept extremely confidential. There are other impediments that limit the usefulness of this method, namely, special purchasers, different negotiating skills, and the distorting effects of the peaks and troughs of economic cycles. In a nutshell, this summarises my objection to such statements as 'this is rule of thumb in the sector'.

- **Cost based methodologies,** such as the cost to create or the cost to replace, assume that there is some relationship between cost and value and the approach has very little to commend itself other than ease of use. The method ignores changes in the time value of money and ignores maintenance.

- The **method of valuation flowing from an estimate of past and future economic benefits** can be broken down to four limbs; 1) capitalisation of historic profits, 2) gross profit differential methods, 3) excess profits methods, and 4) the relief from royalty method.

Discounted cash flow ("DCF") analysis sits across the last three methodologies. DCF mathematical modelling allows for the fact that 1 Euro in your pocket today is worth more than 1 Euro next year or 1 Euro the year after. The account of the time value of money is calculated by adjusting expected future returns to today's monetary values using a discount rate. The discount rate is used to calculate economic value and includes compensation for risk and for expected rates of inflation.

The capitalisation of historic profits arrives at the value of IPR's by multiplying the maintainable historic profitability of the asset by a multiple that has been assessed after scoring the relative strength of the IPR. For example a multiple is arrived at after assessing a brand in the light of factors such as leadership, stability, market share, internationality, trend of profitability, marketing and advertising support and protection. While this capitalisation process recognises some of the factors which should be considered, it has major shortcomings, mostly associated with historic earning capability. The method pays little regard to the future.

- **Gross profit differential methods** are often associated with trade mark and brand valuation. These methods adopt the differences in sale prices, adjusted for differences in marketing costs. That is the difference between the margin of the branded and/or patented product and an unbranded or generic product.sophie This formula is used to drive out cashflows and calculate value. Finding generic equivalents for a patent and identifiable price differences is far more difficult than for a retail brand.

- The **excess profits method** looks at the current value of the net tangible assets employed as the benchmark for an estimated rate of return to calculate the profits that are required in order to induce investors to invest into those net tangible assets. Any return over and above those profits required in order to induce investment is considered to be the excess return attributable to the IPR's and while theoretically relying upon future economic benefits from the use of the asset; the method has difficulty in adjusting to alternative uses of the asset.

- **Relief from royalty** considers what the purchaser could afford, or would be willing to pay, for the licence. The royalty stream is then capitalised reflecting the risk and

return relationship of investing in the asset.

- **Discounted cash flow analysis** is probably the most comprehensive of appraisal techniques. Potential profits and cash flows need to be assessed carefully and then restated to present value through use of a discount rate, or rates. With the asset you are considering, the valuer will need to consider the operating environment of the asset to determine the potential for market revenue growth. The projection of market revenues will be a critical step in the valuation. The potential will need to be assessed by reference to the enduring nature of the asset, and its marketability, and this must subsume consideration of expenses together with an estimate of residual value or terminal value, if any. This method recognises market conditions, likely performance and potential, and the time value of money. It is illustrative, demonstrating the cash flow potential, 'or not', of the property and is highly regarded and widely accepted in the financial community.

  The discount rate to be applied to the cashflows can be derived from a number of different models, including common sense, build-up method, dividend growth models and the Capital Asset Pricing Model utilising a weighted average cost of capital. This appraisal technique will probably be the preferred option.

These processes lead one nowhere unless due diligence and the valuation process quantifies remaining useful life and decay rates. This will quantify the shortest of such as the following lives: physical, functional, technological, economic and legal. This process is necessary because just like any other asset IPR has a varying ability to generate economic returns dependant upon these main lives. For example in the discounted cashflow model it would not be correct to drive out cashflows for the entire legal length of copyright protection, which may be 100 plus years, when a valuation concerns computer software with only a short economic life span of 1 to 2 years. However patent legal protection of 20 years can prevent infringement situations which may be important as often illustrated in the pharmaceutical sector with generic competitors entering the marketplace at speed to dilute a monopoly position when protection ceases. The message is that when undertaking the discounted cashflow modelling never project longer than what is realistic by testing against these major lives.

It must also be acknowledged that in many situations after examining these lives carefully, to produce cashflow forecasts, it is often not credible to forecast beyond say 4 to 5 years. The mathematical modelling allows for this in that at the end of the period when forecasting becomes futile, but clearly the cashflows will not fall 'off of a cliff', by a terminal value that is calculated using a modest growth rate, (say inflation) at the steady state year but also discounting this forecast to the valuation date.

Valuation is an art more than a science and is an interdisciplinary study drawing upon law, economics, finance, accounting, and investment. It is rash to attempt any valuation adopting so-called industry/sector norms in ignorance of the fundamental theoretical framework of valuation.

Conclusion

As mentioned earlier, IPR valuation is more of an art than a science, and while important it is clearly complex. The following general principles concerning the management and valuation of intellectual property allow for making some sense of it all to both the practitioner and the newly inducted.

- **Principle 1** - Make intellectual capital a part of the business strategic thinking and planning. For example risk control, maximising value, being aware of emerging technologies, seek appropriate legal protection etc.
- **Principle 2** - Understanding the role of intellectual capital. Involves assessing the importance of intellectual capital now and in the future to the market position and future success of your business. Part of this is the challenge to identify the intellectual property of others and avoid infringing the associated legal rights.
- **Principle 3** - Be aware of competing intellectual capital.
- **Principle 4** - Know your own intellectual capital. Imply rigorous processes to identify and evaluate the existing intellectual capital in the business, creating a comprehensive record of results and developing a process for identifying future IPR being developed. Positive due-diligence. Successes or not is dependent upon a management process to do just the aforementioned.
- **Principle 5** - Identify required intellectual capital which s a process of forecasting future needs.
- **Principle 6** - Acquire any required intellectual capital.
- **Principle 7** - Think tax and balance sheet.
- **Principle 8** - Be ready to protect your rights.
- **Principle 9** - Measure improvements as an essential part of good intellectual capital management to develop measures of success of the management and evaluation of IPR.
- **Principle 10** - Spread the message because just as important as measuring improvements is communicating a strategy and process, not least via financial PR etc.
- **Principle 11** - Know the cost and value of your intellectual capital.

Kelvin King invites feedback and questions via email valuations@riskrewardlimited.com

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