

## How can you value IP?

Here's a "layman's guide" to the main approaches accountants generally use to assess the value of a given set of intellectual property and intangible assets, with some ideas of their respective advantages and disadvantages.

### a) Cost

The **principle** behind the cost method is to derive a valuation from determining the cost of reproducing or re-creating the IP and intangibles, usually by reference to the actual cost of creation less deductions for obsolescence (which might be functional, physical or economic). In this regard it is closest to the accounting method used by some companies to capitalise their intangibles.

The main **advantage** of the cost method is that it only requires historical data. It can be relatively easy to perform, in some cases simply involving a calculation of labour costs (staff and contractors) based on time expended, plus a suitable apportionment of overheads.

The main **disadvantage** is that cost bears very little relation to market value, as intangibles routinely cost far less (or far more) to create than the economic benefit they contribute. In addition, isolating relevant costs is not always straightforward, and a buyer or prospective licensee can often argue that *its* cost of re-creation would not be the same.

### b) Market

The **principle** behind the market method is to identify similar sales and purchases of comparable assets and set a corresponding value. This is a common method used to establish values for *tangible* assets offered for sale, such as houses and vehicles.

One way of achieving a market valuation is to conduct an open sale or auction, on the basis that this will ensure that the asset realises the value the market attributes to it at that time. However, it is not necessary to organise an actual transaction and place an asset (or set of assets) on the market to derive the valuation - the figure can be based purely on research.

The main **advantage** of the market principle is that the resultant value will be based on prior factual transactions, which ought to provide the most accurate indication of the "arm's length" value of any asset.

The main **disadvantage** is that the input data on comparable transactions is generally very difficult to obtain, for a number of reasons:

- many intangibles are not created with the intention of re-selling them;
- most asset sales happen as part of a business sale;
- where asset sales are separate, they are either conducted under commercial confidentiality or are by definition not comparable with each other, for instance because the organisation is no longer a going concern, meaning that the assets are "distressed".

Comparisons are also made more difficult because intangible assets are, by definition, unique.

### c) Income

The **principle** behind the various income-based methods is that the best way to determine the true value of a set of assets is to estimate the cash benefit that they will generate (or, potentially, save) over a relevant period of time and bring this back to a present day amount.

The key challenge is to isolate the value associated with a particular set of intangibles from the rest of an organisation's value-producing assets. There are a number of different ways to achieve this:

- *Capitalisation of historic profits* – multiplying the assets' economic contribution by a suitable factor, determined by an assessment of their strength, market position and profit trend.
- *Profit differential* – estimating the difference in the profit generated between a particular branded asset and a generic item, as a means of isolating the brand value.
- *Excess earnings* – a “family” of techniques containing a number of variants, all based on the principle that the value of the intangibles in a business can best be determined by subtracting from its overall worth the elements attributable to tangible assets.
- *Relief from royalty* – the assumption that a royalty would be payable by a third party licensing the intellectual assets. This rate can be applied to income streams in order to quantify the financial benefit to the assets' owner from not having to pay the royalty.

The main **advantage** is that the method addresses the need for a market dimension by considering the benefit that the asset will deliver in the marketplace, without the need to reference external transactions.

The main **disadvantage** is that the valuation has to assume that the future income streams (or, potentially, cost savings) will be delivered in practice. Since these are seldom, if ever, certain, most methodologies compensate for uncertainties in the projections by adjusting the discount rate used to bring these future incomes back to an equivalent present day value.

**This is not an exhaustive list and other methods are also used. For example, “options” modelling may be employed in conjunction with income-based techniques where technologies are at a very early stage and have to pass through several “gates” in order to reach the market.**