

Ten common myths about intangibles value and valuation

There are a number of common assumptions that people make about valuing intangibles. Many of these are just plain wrong

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Understanding the value of intangibles is often a confusing and counterintuitive process. Adding to the confusion are the myths that have emerged over the past decade about what makes intangibles valuable and how to measure that value. These myths are based on differing views of what constitutes value, on a working knowledge of value as it relates to tangibles and even on misinterpretations or misunderstandings about rival definitions of value.

Managers of intangibles involved in valuing and extracting value from their firm's intangibles are often challenged by questions and erroneous assertions about value and valuation that are based on these myths. In this paper we identify 10 of the most frequently encountered myths and explain why they are myths, not facts.

What's wrong with myths?

Myths are fables that people believe are true, but are not. A firm that is running its business or managing its intangibles on the basis of myths is making decisions based on assumptions that are not valid. Such firms will be unable to exploit the value of their intangible assets fully and their value may even erode. Once the falsehoods underlying the myths are revealed, it is much easier to make well-informed business decisions related to intangibles.

The myths unmasked in this paper are

discussed under two headings: myths about value and myths about value measurement (valuation).

Myths about value

In a recent meeting among IP brokers, IP sellers and market support companies, the conversation sounded rational, despite the fact that each participant seemed to have an entirely different understanding of the word value. Although the participants thought their meeting had produced a reasonable set of conclusions, days later they realised they had not really understood what each other meant by value. The following several myths are about intangibles and value.

Myth #1 – value is a well-defined and well-understood term

The word value has a range of meanings. Some of them do not overlap because they are associated with separate disciplines: philosophy; sociology; mathematics; music; mining; fine arts; and phonetics. Others, however, do overlap and are of concern here. In the world of intangibles and intellectual property, there are at least five very different business definitions of the word value commonly in use:

- Worth – the value of an item to a specific individual or entity.
- Price – the monetary amount a seller asks a buyer to pay for an item or object.
- Transacted price – the amount actually exchanged in a completed sale.
- Estimate of price – the expected transaction price for a future sale.
- Estimate of worth – a valuation of the current worth of an item to an individual or entity.

The fallacy of this myth is that there is not one well-understood and agreed definition of value. In fact, there are several.

Myth #2 – the value of an intangible is equal to the price someone is willing to pay

To understand the fallacies underlying this myth, one must understand two things: the concept of tangible versus intangible value; and the assumptions underlying the idea that value is equal to transacted price.

All goods have both tangible and intangible components of value. A brief example can illustrate this point. The tangible value of a painting by Rembrandt is represented by the value of the frame, the canvas and the amount of paint daubed on the canvas. This tangible component of the value is not very large. The intangible value, on the other hand, is represented by the artist's interpretation of the scene, the brush strokes and their effect on the texture and interplay of the paints, the mix of colours and the mood they convey, and even the fame or reputation of the painter himself. The intangible component of the value of the painting is far greater than the tangible value.

The idea that value is equal to price is an outgrowth of the neo-classical school of

economic thought that arose in the 17th and 18th centuries. At that time economists were struggling to understand how prices were established in the marketplace for commodity goods. To illustrate, consider three kinds of goods.

Commodity goods are undifferentiated. That is to say, one bushel of wheat in a farmer's silo is no different from another bushel of wheat in the silo. Commodities (undifferentiated goods) have predominantly tangible value. Because neo-classical economists were interested only in the tangible value of undifferentiated goods, the idea that the supply/demand/price relationship represents value for these goods made sense in that narrow circumstance.

Partially differentiated goods are tangible goods that have significant amounts of both tangible value and intangible value. Their price is not entirely driven by the forces of supply and demand. For example, a house has both tangible and intangible elements of value. The

intangible element includes its aesthetic appeal to an individual beholder based on its architectural style, its location, its landscape and its surroundings. These intangible elements of value make its price less subject to the forces of supply and demand.

For differentiated goods, where the tangible portion of value is quite small and the intangible portion of value quite large (eg, a customer list or a software program), supply and demand are considerably less important factors in determining value. The worth of such objects depends on the worth of the object to the specific person contemplating its purchase.

For intangible items, value is rarely equal to price. Price is the amount in currency that a seller asks a purchaser to pay. If the worth of an object to a potential purchaser is greater than the price asked, the purchaser will consider the transaction. If the price asked is greater than the worth of the object to the potential purchaser, it is unlikely that a transaction will occur.

To avoid confusion in this paper, we use the above definitions to clarify what we mean by value in different contexts.

Myth #3 – value is equal to the cost of creating an item

The costs of developing and patenting an invention include not only R&D costs, but also attorneys' fees, the number and complexity of claims, filing fees, the number of countries in which a patent is filed, maintenance fees, the costs of defending a patent in court and so on.

Although these costs may be substantial, IP practitioners have observed that their most valuable patents are those that can be exploited in multiple ways in the marketplace, not those with the highest R&D and patenting costs. Because development costs are uncorrelated with the future economic benefit of a patent to its owner, practitioners rarely use them as a measure of either price or worth.

In rare circumstances, however, cost may be used as an estimate of price. These circumstances arise when an innovation is brand new and a potential purchaser is considering whether to incur the costs of creating the item itself or to pay the seller's asking price. Only under these narrowly defined circumstances can cost be considered as a valid approach for estimating the value of an intangible.

Myth #4 – each intangible should have only one official value

A single intangible may have several very different values at the same time; all of them valid, depending on who owns it and for what purpose it will be exploited.

Because the value of an intangible depends on the context (eg, the resources of the owner or future buyer as well as its so-called complementary assets), the ability to exploit a patent varies from one owner to the next. This means that the ability to create future economic benefit from the patent also varies from one owner to another. Additionally, the different ways to exploit the patent – for example, through out-licensing, as the basis for a new business venture or to protect one's own products – may result in a different set of potential income streams, thus affecting the potential value. Because no company is identical to another, either in context or in potential exploitation scenarios, a single intangible can have very different values for different companies, making it difficult to contemplate a single official value.

Similarly, the value of an intangible is sometimes determined by the rules of valuation that apply in some valuation circumstances. For example, financial reporting (eg, for annual reports or for tax purposes) may be subject to legal, regulatory or standards-based guidelines for

calculating the value of an intangible. Although the specified method may be useful for valuing tangibles, it rarely provides an accurate measure of the value of an intangible to its owner.

Myths about valuation

Valuation is the act of estimating the value of an item, either in the marketplace or to a specific person or entity. Valuation involves methods, processes, judgements, information, data and justification. Following are some myths about valuation.

Myth #5 – the balance sheet provides good information about the value of intangibles

There are three significant problems with using balance-sheet information as the basis for valuing intangibles: not all intangibles are included on the balance sheet; when included, their value is based on the transaction price for which they were acquired, not their worth to the company; and different countries have different rules about whether a firm should include internally generated intangibles on its balance sheet and inconsistent requirements for how that value is to be estimated.

Accounting is a transaction-based system that captures, records and reports information about financial transactions. Accountants count each transaction that occurs inside an organisation as well as with third parties. In the United States, for example, purchased items (those with a transacted price) may be placed on the balance sheet, while internally generated items (those without a transaction price) may not.

International regulations governing public companies are not consistent. For example, US Generally Accepted Accounting Principles (GAAP) say that assets may be placed on the balance sheet only when their presence presupposes their acquisition at a transacted price; self-created intangibles may not be included on the balance sheet because they have no historical transacted price. In contrast, International Financial Reporting Standards (IFRS), mandatory for most European companies, require both self-created assets and externally purchased assets to be listed on the balance sheet on a cost or last-transacted-price basis. But in both cases the balance sheet still contains no information about the worth of a company's intangibles because accounting cannot measure value in context or consider multiple value streams or future economic benefits.

Myth #6 – fair market value is a good construct for use with intangibles valuation

Fair market value (FMV) is an accounting

construct defining the hypothetical price that could be expected to be paid for an object in the marketplace under a fixed set of conditions: an arm's-length transaction; neither party under compulsion to transact; the parties being a willing buyer and seller. In layman's terms, FMV is the average price one could expect an item to sell for in the marketplace. It is a construct that works well where the items at issue are either undifferentiated or partially differentiated because a market for them already exists.

But for items that are wholly differentiated and unique (eg, intangibles), there are usually only a small number of potential purchasers and, for each, the worth of the item will differ, often substantially, from the others. As a result, it is difficult to determine a credible average, or FMV, for a piece of IP.

Myth #7 – there should be only one accepted method for valuing intangibles

Although there are three classic approaches to estimating value – the cost approach, the income approach and the market approach – each approach has a large number of variations. A recent research study (*Value Measurement and Reporting Collaborative Report: "Interpreting and Selecting Measurement Approaches: Strategic Opportunities for the Accounting Profession"*) identified over 100 different methods for measuring intangibles, with roughly half of those concerned with measuring their value. The study concluded that the classic methods are not sufficiently robust to respond to the wide variety of valuation situations. Variations and alternative methods have arisen to provide business management with estimates of value or price that relate directly to a business decision at issue.

The study identified a number of dimensions to valuation and found that each of the various valuation methods uses a different combination of these dimensions. Examples of these dimensions include:

- The purpose of the value estimate (eg, tax issues; financial reporting issues, business decision making).
- The beholder from whose perspective the intangible's value is to be viewed.
- The application of the idea.
- The market segments in which the application is to be involved.
- The method for converting the application into cash (eg, sale, licensing, etc).
- Timeframes (historical value, current value, future value).
- The standard for measuring value – for

example, the firm's market capitalisation, worth to owner, value in transaction, value in a framework (eg, accounting) and so on.

Reaching agreement on one and only one method for valuing intangibles would mean coming to an *a priori* agreement on the dimensions for all valuations. At the present time it is unlikely that the business community will be able to agree on one set of dimensions for estimating either price or worth.

Myth #8 – a current estimate of future price must equal the eventual transaction price in order to be considered accurate

Some people believe that the true test of the quality of a current estimate of a future transacted price is whether, when the transaction eventually occurs, the actual transacted price is equal to the previously estimated future transaction price. In other words, the actual transacted price must equal the previously estimated transaction price or else the estimated transaction price is wrong.

The best estimate of a future price is one that is based on the best current information and the best current judgements. These judgements and pieces of information are then extrapolated into the future using the most credible methods available. When can an estimate be considered best? Whenever there is no better or more credible alternative estimate. This is true both for intangibles and for tangible business assets, but getting the best estimate is more difficult for intangibles because of their more complex characteristics.

Myth #10 – The value of a company's intangibles is the difference between its market value and the value of its tangible assets

This simplistic view of the firm's intangibles is both misleading and wrong. First, this myth uses an apples-to-oranges comparison of dollar amounts. For example, a company's market capitalisation (the current share price multiplied by the number of shares outstanding) is determined by current negotiations between buyers and sellers of the company's stock in the open market. The dollar values used are current and are based on market information about the company and expectations for its future performance. The value of the firm's tangible assets, on the other hand, is based on the asset prices negotiated by a different set of buyers and sellers in different markets at a different point in time, and on transaction prices that occurred in the past. The value of a company's market capitalisation and the

value of its tangible assets are numbers that are incommensurable. That is to say, although they are both denominated in dollars, the dollars are not compatible and cannot be added or subtracted from one another.

Second, this myth relies heavily on the assumption that buyers and sellers of a company's stock are making their purchase or sale decisions based on their beliefs about the value of the totality of the company's intangibles. Although a small number of buyers and sellers may indeed make decisions with this in mind, it is unlikely that most do.

While this myth may have a comforting simplicity about it, it is nevertheless a myth and is simply not true.

Intangibles are different

While the art of valuation has advanced significantly in both financial reporting and the calculation of litigation damages, it has not progressed as far in supporting businesspeople and their valuation needs. There is, in fact, no relationship between the valuation methods used for financial reporting or litigation damages and the valuation methods needed to support business decisions or business transaction relating to intangibles. In the business of financial reporting, which is based on US-GAAP or IFRS, value is equal to price. But businesspeople responsible for managing IP and IA in the firm think of value as the worth of an item to their own company or to a potential purchaser or licensee.

Intangibles value is different from tangibles value in part because the value of tangibles is based on rational assumptions about supply, demand and price. The business value of intangibles, on the other hand, is closely associated with worth; and worth varies from one beholder, or user, to the next.

Only recently has it been acknowledged that valuing intangibles for business purposes is different from valuing them for financial reporting purposes. Understanding the difference between these two purposes and their underlying assumptions is an important step forward for intellectual asset managers. *iam*

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There are two fallacies underlying this myth. The first is that the value of intangibles is less possible to estimate than the value of tangibles. The second is that intangibles cannot be credibly valued because of the complexity of the valuation process.

People who believe this myth appear to suggest that the value of an intangible (either worth or price) is less able to be estimated than that of a tangible, whose value may be estimated with greater certainty. And they argue that because intangibles are so highly differentiated and involve so many factors, their valuation cannot be credibly accomplished. People in this camp often assign a value of zero to intangibles, arguing that since we cannot determine their value credibly we should arbitrarily assign them a zero value.

But sophisticated intellectual asset (IA) managers understand that intangibles and tangibles have different characteristics and that these affect their value. The two major differences that affect their valuation are these: intangibles have value only in context, and they are capable of generating multiple simultaneous value streams. IA managers have identified more than two dozen types of commercial value that companies receive from their intangibles. From their perspective, any differences between tangibles and intangibles lies with their valuation and not with the kinds of business value they provide.

People who believe intangibles cannot be valued credibly confuse credibility with certainty. They seek the comfort of established markets and market prices, such as one finds for automobiles, tables, chairs and other kinds of tangible object. But the lack of established markets and prices does not mean that the value (either price or worth) cannot be credibly estimated.

Although a complex activity such as estimating value requires good business judgements and data, IA managers make value estimates for intangibles every day in support of their ongoing business operations. Further, the past decade has seen significant improvements in our knowledge and in our methods for valuing intangibles. We now understand the dimensions of valuation (see Myth #7) and we understand the special characteristics of intangibles that affect their value and valuation. We have more and better data and information about their use in business and commerce, and more examples of those uses.

Intangibles do have value, just like tangibles, and both their worth and their price can be credibly estimated in support of business decisions.