

Maximising the financial value of IP assets



Azuka Dike demonstrates the importance of IP in the information age

How vital can IP be to a company's balance sheet? Just ask GoPro. The company's shares fell 13% after Apple was awarded a patent for a potentially competing wearable video camera. While Apple may never pursue the camera commercially, the announcement alone erased more than \$800m from GoPro's market value in a matter of hours.¹

Traditionally the primary influence for obtaining IP has been to protect the core functions of a business and to safeguard future innovation. However, as we transition from an industrial economy based primarily on the exchange of physical assets to an information-based economy, IP has become a valuable resource for many businesses. For example, in 1975 intangible assets including IP comprised only 17% of the market capitalisation of S&P 500 companies. Over the past four decades this ratio has increased to 84%.² This long-term and likely permanent trend of utilising IP as an economic resource has forced businesses to differentiate themselves from competitors through innovation. Many companies have even adopted this belief in their branding. Examples include 3M ('innovation'), Compaq ('invent and inspiration technology'), General Electric ('imagination at work') and Panasonic ('ideas for life').

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should be considered financial assets. And if so how can they efficiently extract real value and drive economic performance from those portfolios?

Recognising IP as a financial asset

Assets are resources controlled by an entity and held for the purpose of generating future economic benefit. Generally accepted accounting principles (GAAP) recognise two types of assets – tangible and intangible. Tangible assets take on a physical form and derive current or future value from the physical property itself (examples include, inventories, real estate, buildings and equipment). Financial assets constitute a subset of tangible assets whose value is derived from a contractual claim, such as cash, bonds and stocks. Bonds, for example, are considered financial assets because they provide the owner with a certain rate of return or may be sold prior to maturity to generate revenue. Intangible assets, on the other hand, are non-monetary resources lacking a physical form that arise from a contractual or other legal right. Examples include patents, copyrights, trademarks and goodwill. In the case of patents an owner has the right to exclude others from enjoying the benefits of an economic resource, such as making, using or selling inventions.

GAAP provides some guidance for determining whether IP and other intangible assets should be considered financial assets. Under current accounting rules, companies recognise financial assets on their balance sheet at fair value, that is the amount at which the asset could be bought or sold in a current transaction between willing parties or transferred to an equivalent party.³ However, accounting for IP on a balance sheet depends primarily on whether the IP was internally generated or acquired. For example, companies treat internally generated IP as a current operating expense and do not record it as an asset on their balance sheet. While legal fees and filing costs associated with IP may be considered intangible assets, these costs may not correlate to the economic value of the IP. Thus unlike financial assets a company's internally generated IP may be recorded as having little or no asset value until an IP transaction occurs. By contrast, acquired IP is

reflected as an intangible asset on the balance sheet of the acquiring company at an allocated purchase price.

Treating IP as a financial asset

As global IP transactions increase companies are adding IP assets to their balance sheet at an unprecedented rate. Whereas IP assets are packaged with other intangible and tangible assets to be traded on securities exchanges as a more traditional financial asset, the expectation of future economic benefits derived from IP, and patents in particular, may not be as ostensible in comparison.

Substantial differences exist between transactions involving traditional financial assets and IP assets. Financial assets such as stocks are governed by securities regulations and are structured to reduce buyer risk by facilitating safe, dependable securities transactions. These safeguards together with established financial exchanges have led to an increase in financial asset transactions, which permit companies to more efficiently exchange market information and determine the value of available financial assets. Conversely, IP markets typically do not share these same characteristics. The lack of transparency and information surrounding IP has made it increasingly difficult to conduct transactions at a frequency that produces economic value. In many instances, prospective IP transactions do not occur because it is too challenging for buyers and sellers to find each other.

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Additionally, the rate of IP transactions has also been depressed given that the economic value derived from IP can be tied to the maturity of the underlying right and impaired by future events. At the early stages of IP a prospective owner may have little if any information to determine future cash flows that can be derived from the IP right prior to implementation. For example, initial sunk costs are necessary to create or acquire a patent right. This includes costs to research and develop the underlying technology as well as costs to file and prosecute a patent application. In the event that first a patent issues and secondly the scope of the patent is not unreasonably narrowed during prosecution (eg, it remains consistent with the initial expectations of the owner at the time of filing), the economic value of the resulting patent can still be curtailed by future events such as estoppel, litigation or post-grant proceedings. Equally, if the patent fails to generate revenue during its lifespan and/or prior to obsolescence, the patent right may result in negative cash flows such as maintenance fees for the owner. Accordingly, companies may be less willing to accept tolerable risks associated with creating and developing new IP when expected returns and economic value cannot be ascertained prior to pursuing the IP right.

As market transparency improves in relation to the frequency of IP transactions, companies may begin to invest more resources in gathering and sharing market data. This may eventually lead to a level playing field for market participants and a likely progression towards treating IP more like financial assets. Ultimately, while IP may not exhibit all the characteristics of a financial asset, it will continue to be an important measure of a company's market value. As such, IP portfolios must be judiciously managed like any other financial asset in order to maximise future growth and economic value.

Best practices for evaluating and monetising IP portfolios

Generally, the goal of every business is to maximise profits and minimise expenses. This principle should apply equally to financial assets and IP assets alike. Consequently, to maximise the value of an IP portfolio, companies must:

- Treat your IP portfolio like a financial asset. Make calculated decisions to maximise the expected value of your portfolio. Many companies evaluate strategic IP decisions in terms of the estimated impact on reported earnings rather than focusing on the expected incremental value of future cash flows for each IP asset in their portfolio. To maximise portfolio value you should evaluate alternative IP strategies in view of their effect on expected value and susceptibility to shifting competitive and legal landscapes.
- Adjust your business plan to ensure IP assets are applied profitably across most business activities. Adopt IP management procedures that promote the exchange of value-relevant information between business sectors so that you may quickly respond to changing market conditions and leverage potential IP transaction opportunities. Periodically conduct detailed portfolio assessments and develop objective economic performance indicators for your IP portfolio. This data can be utilised to increase the overall transparency of your portfolio's value, thus reducing risk and transaction costs for potential buyers.
- Seek out new opportunities to monetise your IP portfolio by considering estimated value creation during all phases of IP development/implementation. Consider new methods of generating revenue from your current IP portfolio by identifying underutilised or undervalued IP assets, determining whether and how best to monetise these assets (eg, licensing, selling etc), and acquiring IP to further strengthen your strategic (offensive and defensive) position within the competitive marketplace.
- Do not prioritise portfolio quantity over quality. Many companies focus on creating large portfolios of IP assets, despite the fact that much of their current portfolio remains unexploited. Take an inventory of IP assets to determine the status of relevant value-creating IP activities and pursue IP transactions that maximise the expected value of the overall portfolio. Carry only IP assets that maximise portfolio value and license or sell IP assets that fail to generate value or returns above your cost of capital. Track the quality of acquired or internally generated IP assets using objective criteria, as well as their relationship with and contribution to the total value of the portfolio.

Footnotes

1. Apple's new video camera patent sends GoPro's shares into a tailspin, *Forbes*, 13 January 2015.
2. Components of S&P 500 Value, Ocean Tomo, available at <http://www.oceantomo.com/intellectual-capital-equity>.
3. US GAAP (Statement of Financial Accounting Standards, SFAS 157).

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