5/25/10

How does IC/IP identification and valuation affect the bottom line of the business?

http://www.icknowledgecenter.com/forum/topics/how-does-icip-identification?xg_source=activity

There seems to be a huge disconnect between the academic and intellectual discussions on this and similar sites and the real world of business. A business owner is interested in IC/IP identification and valuation only to the extent that they positively impact the bottom line, reduce taxes, or, at the time of sale, increase the value of the firm.

Economic theory teaches that business owners should make decisions that maximize the value of the firm. This theory could be extended to maximizing profits of the firm as well. That is the ideal but, for numerous reasons, rarely accomplished in the real world of small to medium sized businesses (SMB).

The typical SMB owner is more concerned with minimizing taxes, keeping customers, assuring that his banker is happy, and having sufficient cash flow to meet payroll.

Unless the identification, valuation and monetization of IC/IP can be brought down to the ground level of the firm, unless IC/IP identification and valuation has a direct impact on those issues foremost in the minds of SMB owners, there is no way SMB business owners will care a hoot about intellectual capital or intangible assets.

At my current level of understanding of this very complex issue, which I have been studying and researching off and on for the last five years, it seems to me that the institution having the most impact on this issue for SMBs is the firms' accountant. For the typical SMB, that accounting firm is a local or regional firm which may or may not be up to speed on the issues revolving around identification and valuation of IC/IP.

Rather, the accounting firm works at the direction of the client who is most interested in minimizing the amount of taxes owed which thus controls the entire directional thrust and activity of the relationship between accountant and client. It is unimaginable to me that a CPA, while auditing the books or preparing taxes of a SMB client, would take the time to explain the complex issues of IC/IP and its potential impact on the client's business.

Furthermore, with the accounting profession continuing to operate as if we were still living and working in the 19th Century, there is little chance of this issue ever being brought to the fore by the accountant on duty. His job is to bill the most amount of time he can reasonably get away with and still keep the client happy.

Thus it falls on the accounting profession itself to change its thinking, which in turn will affect the rules promulgated by the Internal Revenue Service, which will then trickle down to the level of the firm and guide the accountants' work for clients who wish to minimize taxes under generally accepted accounting principles while complying with IRS regulations.

It is a fact that public companies already recognize IC/IP on their balance sheets. It only takes a quick perusal of balance sheets on the SEC's Edgar site to confirm how widespread that recognition is among publicly traded companies. Could it be that the leading international CPA firms do, in fact, recognize and value intangibles? Perhaps we should ask them.

I have personally been engaged in M&A transactions where millions of dollars of value was stated on balance sheets of several companies for such things as recipes, brands, customer lists and engineering drawings; all of which, by the way, are recognized by the IRS as Section 197 intangible assets which can be depreciated under current IRS regulations. See this link under the title: *"Section 197 Intangibles Defined"*

http://www.irs.gov/publications/p535/ch08.html#en_US_publink1000208966

The only grey area remaining in my mind is if such intangible assets can be depreciated when internally generated rather than acquired. The IRS does not allow depreciation of internally generated IC/IP assets; they must have been acquired. Yet, again, in the same M&A transactions previously cited, at least one company had millions of dollars of value on the balance sheet for intangibles and had never completed an acquisition!

While the intellectual discussions of these issues will go a long way to changing the accounting profession's treatment of intangible assets, it remains for practitioners to raise the level of awareness among SMB owners so they can, indeed, benefit from the recognition of intangible assets that often make up the majority of their company's value.