

European Trend Chart on Innovation

Trend Chart Policy Workshop

"Valorising the Innovation Capacity of the Firm"

The value of intangible assets in the knowledge economy

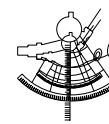
Brussels 27-28 September 2005

Hotel President World Trade Centre
(Koning Albert II Laan/Boulevard du Roi Albert II, 44)

Scoping Paper

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*The contents of this paper have not been verified by the European Commission and do not necessarily
express the position of the European Commission*



European Trend Chart on Innovation

Introduction

The European Union is facing a paradigm shift from a traditional industry driven economy to the new knowledge based economy. This is impacting on every facet of life and requires a radical transformation of Europe's economy and society¹.

In the knowledge economy skills, market and technical knowledge, networks, business relationships, are important drivers for a companies' ability to innovate and gain competitive advantage². Traditional physic assets such as manufacturing plants, machinery, inventory are no longer the key assets in the knowledge economy and considerable emphasis is placed upon the creation and safeguarding of intellectual property rights (IPR) such as copyright, patents, trade marks, design rights and other "soft" factors such as competencies, innovation management skills, know-how, networks. These assets do not have a physical substance and are therefore defined as *intangibles*^{3,4}. IPR but also a companies' capability to manage the innovation process are key aspects of the 'intangible value' of a company, but the main challenge is how to measure and value these intangible assets.

A number of studies have been undertaken by the Commission to explore this issue of valuating intangibles and seeking to offer companies some reference on the most appropriate ways to prepare intellectual capital statements⁵. This Trend Chart workshop contributes to this process and explores how the Commission could

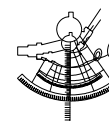
¹ EC Lisbon Agenda 2002

² Increase of productivity – increase of economic output not attributable to increase in input of labour or capital – is attributed to technological improvements (either more efficient use of existing equipment or replacement of existing equipment by more efficient technologies.

³ Previous studies have shown the difficulties in defining intangibles. For instance there is discussion whether the definition of intangibles should encompass "soft" factors such as competencies or whether it should be limited to those factors over which legal rights have been assigned, such as patents, trademarks and copyrights.

⁴ Financial assets (e.g. cash, equities, bonds) are considered tangible assets.

⁵ See for instance DG RTD MERITUM project (Measuring Intangibles to Understand and Improve Innovation Management) - *Guidelines for Managing and Reporting on Intangibles – Intellectual Capital Report*, (2002); DG INFSO PRISM project (Policy making, Reporting and measuring, Intangibles, Skills development, Management) on management and measurement of intangibles (<http://www.euintangibles.net/about/index.html>); DG ENTR study on *The measurement of intangible assets*, April 2003; DG MARKT E/3 study on *Defining intangibles*; DG MARKT D/2 study on *Economic and social value and commercialisation of patents*



European Trend Chart on Innovation

stimulate the development of guidelines for valuating intangibles and to what extent public support instruments can be used to valorise the innovation capacity of the firm.

Two issues will be discussed in more detail during the workshop. Firstly the inclusion of intangibles assets like IPR in financial reporting so companies can have better access to external finance. Secondly, valuation of companies' innovation management capabilities and techniques applied to turn ideas into products and services. This is an important prerequisite to translate IPR assets into commercial success, but for external investors it is difficult to assess to what extent a company masters these capabilities. During the workshop it is explored how Innovation Management Certification as a self-assessment tool can be used to improve a companies' innovation potential and to use as a quality label for investors. These topics will be described in more detail below.

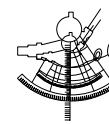
Intangibles as collateral for debt financing

Debt financing is the largest source of external financing for SMEs. Equity finance through business angels or venture capital funds represent only a very small part of overall external finance for SMEs⁶. For both forms of finance, investors ask for collateral to back the investment. The value of the firm is taken as a reference for this financing.

Companies, especially Small and Medium Sized Enterprises (SMEs) and New Technology Based Firms (NTBFs) have difficulties accessing finance. These companies spend large sums developing new products and services which they protect by registering intellectual property through patents, copyrights and trade marks. They then need to take their ideas to market and often require additional funding to turn their ideas into saleable goods or services.

However, these firms will often neither have a market reputation nor significant tangible assets which may be used as collateral when applying for a bank loan. While

⁶ In the UK private equity only accounted for 3% of external finance for SMEs from 1991-2000. Bank of England Report, Finance for small firms, Eighth Report, as quoted in Davies, 2004.



European Trend Chart on Innovation

multinational companies often have sufficient “hard” assets that can be used as collateral for raising debt finance SMEs and New Technology Based Firms often have only intangible assets like IPR.

When assessing collateral for loans banks look for assets of the business as shown in the balance sheet, but IPR does not appear on the balance sheet or only at cost value. Banks appear not to have developed a standard or guideline for treating IP with respect to e.g. credit extension. As a result the SMEs and NTBFs have difficulties to use their IPR to obtain debt financing which is the largest part of overall external financing for SMEs. According to Davies, such under-utilisation of intangibles like IPR as collateral may be impacting upon the survival of small technology-based firms where their principle assets are their IPR.⁷

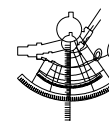
Accounting rules on IPR

Intellectual Property Rights (IPR) are “property” in the sense that it can be bought, sold, licensed or traded in the same way as any other form of property. As such, IPR rights represent important intangible assets for companies and often comprise the foundation for market dominance, as well as continuing profitability for leading companies. Patents have become an increasingly important part of companies’ portfolios. The rise in importance of patents is reflected by the increase in patenting over the years as shown by the European Innovation Scoreboard.⁸ This importance is however not reflected in the balance sheet.

Current accounting rules for companies quoted on a regulated market in the EU, only allow for intangible assets, to be recorded on the balance sheet if these are (1) identifiable, (2) controlled by the enterprise and (3) from which future economic benefits are expected to flow to the enterprise.⁹ When recognised an intangible asset should be carried at its cost less any accumulated amortisation. An intangible asset

⁷ Professor Iwan Davies, 2004, Swansea University, *Financing of Welsh SMEs and the Commodification of IP Rights*, <http://www.ipwales.com/fe/default.asp?n1=1&n2=6&n3=8>

⁸ SEC(2004)1475



European Trend Chart on Innovation

may be carried at a revalued amount only if fair value can be determined by reference to an active market. The IPR value is therefore mainly based on the costs, whereas several other methods have been developed that reflect the market value more adequately.

The question that the workshop will explore is how the access to finance can be improved for SMEs and (high-tech) start-ups based on their IPR. The primary objective is to investigate the possibilities for the financial community within the current rules to provide financing based on companies' IPR.

Innovation Management

Another key aspect of the 'intangible value' of a company is its capability to manage the innovation process. An important criterion for private investors to finance a company is the trust it has in the management of the company, whether headed by a single entrepreneur or a larger management team. However there are few standard measurements to establish this innovation management capability.

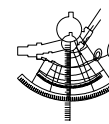
Previous European studies on innovation management have underlined that companies must stand up to the challenge of turning innovation into competitive advantage in the marketplace, by obtaining useful knowledge of the existing experience and utilizing results in the field of Innovation Management Techniques.¹⁰

EU initiatives such as PAXIS (<http://www.cordis.lu/paxis/>) and Gate2Growth (http://www.gate2growth.com/g2g/g2g_welcome.asp) provide clear evidence that companies, and especially SMEs, encounter difficulties in the planning, implementation and commercialisation of innovation. These difficulties can be observed in several areas such as:

- Missing or insufficient strategies for the management of Intellectual Property;

⁹ International Accounting Standard 38. Intellectual property rights which are not fulfilling the above mentioned conditions will be recognised as (part of the) "goodwill" only in case of mergers and acquisitions.

¹⁰ Innovation Management, Building competitive skills in SMEs, European Commission, DG Enterprise, 1999



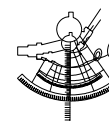
European Trend Chart on Innovation

- Insufficient quality of business plans and business presentation to the finance community;
- A lack of awareness of available new technologies to support the modernisation of business processes, such as e-business;
- Little understanding of non-technological innovation as a tool to enhance productivity and competitiveness;
- Poorly developed marketing strategies for new markets, public procurement and blue chip companies;
- Poor usage of new state-of-the-art standards due to a lack of awareness or organizational resistance.

Nevertheless many enterprises seem hesitant to seek (external) expertise to better manage the innovation process, and as a result the innovation performance of many European enterprises may be suboptimal. A study ‘Innovation Management and the knowledge driven economy’ concludes that many companies lack the experience in Innovation Management Techniques (IMTs) and few national or regional programmes specifically address the promotion of IMTs.¹¹ Enhancing the innovation management skills of the SMEs and providing a **certification** to the fact the companies have incorporated these competences, could help entrepreneurs to increase the (intangible) value of their company. If this certification is of sufficient high quality and robustness, external investors (banks, venture capitalists, business angles, etc) might accept this label as an additional guarantee that the company has put in place ‘good management practices’ and therefore forms a lesser risk for investment. The European Commission would like to explore whether such an innovation management certification, would first of all be accepted and utilized by the companies, could be implemented in a user-friendly manner and last but not least be accepted by external investors as a dependable label.

Scope of the Workshop

¹¹ Innovation management and the knowledge-driven economy, January 2004, European Commission, DG Enterprise



European Trend Chart on Innovation

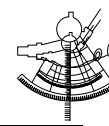
The aim of this Trend Chart workshop is to explore how the Commission could stimulate the development of guidelines for valuating intangible assets, especially IPR and to what extent public support instruments can be used to valorise the innovation capacity of the firm. In particular the potential usefulness of *Valuating IPR* and *Innovation Management Certification* will be discussed during the Workshop. As these instruments do not exist at this stage the Commission services will collect information on the stakeholders interest with regard to these initiatives.

During the Workshop the following topics with regard to **valorising IPR** will be discussed:

- Is it relevant to modify the way intangibles (IPR) are valued so intangibles will be included on firms' balance sheets?
- What types of companies (multinationals, SMEs, high-tech starters, etc) have difficulties raising finance as a result of under-utilisation of intangible assets like IPR as collateral?
- Have there been any initiatives at a national level to develop guidelines, outside of the formal accounting rules, for valorising patents?
- Nowadays patents are evaluated on the base of their development costs. Are there alternative IPR asset measurement methods that take into account their contribution to future firm revenue? Are these methods accepted by banks and venture capital?
- To what extent will better methods to value intangibles (IPR) have an impact on the access to finance?
- What are the experiences in the US with FAS 141 & 142, and what have EU companies done to comply?

During the Workshop the following topics with regard to **Innovation Management Certification** will be discussed:

- Are there any existing innovation management tools used to convince financial institutions of the performance and potential of a company? Are these tools satisfactory to both private companies and financial institutions?
- How could a certification of innovation management practices be implemented?
- What should such a certificate consist of to make it acceptable for financial institutions (e.g. what information should be certified)?
- To what extent will the implementation of innovation management certification help companies to launch a new products or activity?



European Trend Chart on Innovation

- To what extent would an EC certification have an impact on access to finance for SMEs and start-ups?
- What advice can be given to establish a “credible” EU certification?

Workshop participant profile

The target group for the workshop is:

- IPR institutions (e.g. European Patent Office)
- Private sector organisations dealing with commercialisation of intangible assets (e.g. specialised consultancies, patent lawyers, accountants)
- Investors (e.g. business angels, seed venture capitalist),
- Financial institutions (e.g. European Banking Federation, EVCA)
- Private companies supported by a public scheme that can share their experiences
- Academics particularly if involved in business process aiming at commercializing results from university research.
- Support agencies (development agencies, research institutes) with experience in the field of innovation management/ certification schemes
- Policy makers involved in shaping public schemes to bridge the gap between invention and innovation, between new ideas and commercial applications (including financial instruments)

The workshop is a ‘by invitation only’ event. To ensure interactive learning between the participants the number of participants is limited. Invitations will come from DG Enterprise and Industry.