# Valuation and Accounting of Intellectual Property Rights


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**Intellectual Property Right (IPR) being an intangible asset can either be 'acquired' or 'self-developed'. Existing accounting standards are available in respect of an intangible asset in AS-26 (Indian), IAS-38 (International) and FAS-142 (American). There is no specific national or international accounting standard as regards IPR. From a survey of a few Indian companies' annual reports, it has been found that they follow arbitrary techniques, mostly in line of accounting for Research and Development (AS-8), regarding valuation and accounting of intellectual property rights. In this backdrop, this article attempts to outline a roadmap for valuation and accounting of IPRs with a synthesis of the standards mentioned.**

An Intellectual Property Right (IPR) is an exclusive right given by the Government of a country to an individual or an organization for something created out of intellect. There are seven types of Intellectual Property — (i) Patent (ii) Trademark (iii) Industrial Design (iv) Topographical Design of Integrated Circuit (v) Geographical Indication (vi) Trade Secret & Undisclosed Information (vii) Copyright. These cover almost all types of assets that can be created by one's own intellect. However, India, as of now, recognizes only three of them – Patent, Trademark and Copyright. Intellectual Property Right became an important topic for Government and the industries alike only after the WTO came into being in 1995. And that too because of the binding provisions of the TRIPS agreement which is coming into force from the 1st of January, 2005.

The number of patents filed by the Indian companies to the United States Patent and Trademark Office (USPTO) rose from 48 in 1997 to 613 in 2003. That is a substantial jump in percentage terms but pales in comparison to the sheer volume of patents being cornered by the US, Japanese and German companies. US companies received 98,666 patents in 2001 vis-à-vis 69,922 patents in 1997. Though patent is a national subject, but to protect an invention overseas, one needs to have an international patent. Nonetheless, the gradual movement of Indian companies towards an

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IPR-based world bodes well for India in general and Indian companies in particular in the years to come.

## Need For Accounting of IPRs

As more and more Indian companies jump into the IPR bandwagon and develop newer and newer types of IPRs, the need is being felt to value these IPRs in a just and reasonable manner. The valuation technique should not only follow the usual accounting conventions and principles, but should also be in tune with those followed by the advanced countries. The accounting conventions that should be adhered to include the Doctrine of Conservatism, Doctrine of Materiality, Doctrine of Consistency etc.. In the following passage, valuation and accounting of Copyright and Geographical Indication (GI) have been deliberately left out. That is because Copyright is a non-industrial type of Intellectual Property while GI is taken by the Government and the protection is enjoyed by all the companies located in the particular geographical region. Hence accounting of these two types of IPRs require some special treatment.

An IPR is nothing but a type of intangible asset and hence the standards followed to account for the same is also relevant to measure an IPR. The earliest standard regarding accounting and valuation of intangibles can be found in SSAP 22 on "Accounting for Goodwill", following which it was mandatory for all British companies to show 'acquired goodwill' as an asset in the balance sheet. However, understanding the importance of "non-goodwill intangible assets", the IASC issued Exposure Draft, E-50 , in June 1995. As per the IASC Exposure Draft, "An intangible asset should be recognised as an asset when (a) it is probable that future economic benefits associated with the asset will flow to the enterprise, and (b) the cost of the asset in the enterprise can be measured reliably". This draft ultimately was transformed into **IAS-38** as the international standard for valuation of intangible assets. The Accounting Standard Board (ASB) of The Institute of Chartered Accountants of India (ICAI) understood the importance of Intangible assets and introduced **AS-26** (replacing AS-8 in the process) as the procedure to be followed to account for intangible assets by Indian companies. The provisions of the American law regarding intangible assets can be found in **FAS-142** .

## Valuation of IPRs

An Intellectual Property Right is foremost an asset – a type of property right given by the Government to an individual or an organization for a specific period of time. But, being a right, it is an intangible asset. The intangible asset may fall in either of the two categories – 'Acquired' and 'Self-Developed'. Let us first take a look at what the various accounting standards have to say regarding the valuation of intangible assets.

| IAS – 38 | AS – 26 | FAS – 142 |
|---|---|---|
| **1.** An intangible asset is initially recognized at cost if and only if,<br>■ Asset is identifiable and is controlled and clearly distinguishable from an entrepreneur's goodwill.<br>■ Future economic benefits will be derived from the asset<br>■ The cost of the asset can be reliably measured | **1.** An intangible asset is initially recognized at cost if and only if,<br>■ Asset is identifiable and is controlled and clearly distinguishable from an entrepreneur's goodwill.<br>■ Future economic benefits will be derived from the asset<br>■ The cost of the asset can be reliably measured<br>This requirement applies to internally generated or acquired intangible asset. If the intangible asset does not meet the above criteria, the expenditure is to be treated as cost. The cost of an intangible asset comprises of its purchase price, including any | **1.** The provisions came into effect on and from 15/12/2001.<br>**2.** Intangible assets acquired individually or as a part of group should be accounted for upon their acquisition.<br>**3.** Cost of developing, maintaining and restoring intangible assets that are not |

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**2.** An intangible asset should be measured under any one of the following treatments :-

- Historical cost less any amortisation and impairment losses
- Fair value less any amortisation and impairment losses

The fair value can be determined from an active market.

import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use.

**2.** The generation of an intangible asset should be classified into a research phase and a development phase. All expenditure in the research phase is to be treated as revenue expense. The expenditure in the development phase can be recognized if –

- The asset can be developed into a saleable product
- The firm wants to sell/use the product
- The firm has the ability to sell the product
- The asset will generate future economic benefits for the firm.
- The benefits can be measured reliably.

The standard requires that if an intangible asset does not meet the criteria, it is required to be expensed when incurred.

specifically identifiable are recorded as revenue expenses when incurred.

So in the light of these standards, the ideal way to value these IPRs can take the following shape:

### Acquired IPR

If the Intellectual Property Right is acquired, then the acquisition cost becomes the value of the IPR. This cost normally includes the amount expended by the original holder to develop the IPR and also a *premium* representing the Net Present Value (NPV) of the expected future profits to be earned by the new owner. After all, this cost is determined after a 'hard bargaining' and only attempts to cover the cost (which is highly subjective in nature so far as the premium part is concerned) mentioned earlier.

### Self-Developed IPR

For a self-developed Intellectual Property, the process of accounting will get a little bit complicated. Inventing a new product is a time-consuming process where success is not guaranteed. If the Research and Development work does not yield anything concrete, the investment cannot be converted into an IPR. In this case the entire expenditure has to be written off through the Profit & Loss (P/L) Account as revenue expense. In this case the value of the IPR will be 'zero'. But if research leads to an IPR then the sum-total of expected future sales over its life-period should be taken as the value of the IPR. Also the cost incurred by the organization to file for the IPR and to search for the existence of any similar type of Intellectual Property should be included in the total value of the IPR. In this connection, an idea of such cost can be obtained from the schedule of the cost of filing for a patent under the Patent Cooperation Treaty (PCT), 1970.

The schedule of such cost is given as follows:-

| *Particulars* | *Swiss Franc* |
|---|---|
| Basic Fee (up to 30 pages) | 650 |
| (more than 30 pages) | 15 for every extra page |
| Designation Fee (for one country) | 150 |
| (for more than one country) | 1650 |
| Handling Fee | 233 |
| Search Fee | As proposed |

**However if the applicant comes from a country having per capita income (p.c.i) of less than $3,000 then the fees are reduced by 75%. So the minimum cost expected to be incurred by an Indian applicant per IPR (p.c.i of $2.840 under purchasing power parity) will be about S.Fr. 250, after the 75% discount. This comes to around Rs.9,000 (S.Fr.1=Rs.36).** This valuation exercise will help the company in case it wants to sell the IPR to someone else. It will help the company to quote a price for sale,

and also to account for any gain/loss made in the transaction in a prudent way.

## Accounting for IPRs

Valuation and accounting of assets go side by side. Let us again take a look at what the various accounting standards have to say regarding accounting of intangible assets.

| IAS – 38 | AS – 26 | FAS – 142 |
|---|---|---|
| **1.** Intangible assets should be amortised over the best estimate of their useful life, which usually should not exceed 20 years from the date when the asset is available for use.<br><br>**2.** If the useful life of the intangible asset exceeds 20 years, the firm should amortise the asset over its life and test the asset for impairment annually in accordance with **IAS-36** and disclose the reason why the asset will have a life of more than 20 years. | **1.** The depreciable amount of an intangible asset is to be allocated on a systematic basis over the best estimate of its useful life.<br>**2.** The life of an intangible asset should not exceed ten years from the date when the asset is available for use.<br>**3.** If the intangible asset is acquired legally, then its life can exceed the legal rights if the rights are renewable.<br>**4.** The amortisation charge for each period is to be recognized as an expense.<br>**5.** The residual value of an intangible asset should be zero unless at the end of its useful life it has an active market or a third party has committed to buy it after the period.<br>**6.** The amortisation period and the method should be reviewed each year and changed if required.<br>**7.** Any profit or loss made on disposal of an intangible asset should be disclosed as income or expense in the P/L Account. | **1.** The accounting procedure involves determining an initial carrying amount, accounting for that amount after acquisition under normal business conditions, and accounting for that amount if the value declines substantially and permanently.<br>**2.** The intangible assets having a finite life are to be amortised over their useful lives, but without the constraint of an arbitrary ceiling.<br>**3.** Intangible assets that have an indefinite useful life, are not required to be amortised. They are required to be tested for impairment in a two-step process at least annually by comparing the fair values of those assets with their recorded amounts. |

Apart from the above recommendations, almost all the standards have a set of disclosures to be made which are quite similar to each other. The **disclosures** needed to be made for each class of intangible assets, distinguished between internally generated intangible assets and other intangible assets, are as follows:

- The useful lives or the amortisation rates used;
- The amortisation methods used;
- The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and at the end of the period;
- A reconciliation of the carrying amount at the beginning and at the end of the period showing –
  - additions from internal development and/or through amalgamation
  - retirements and disposals
  - impairment losses reversed in the statement of profit and loss (if any)
  - amortisation recognized during the period
  - other changes in the carrying amount during the period
- If the intangible asset is amortised over more than ten years, the reason for it should be disclosed.
- A description, carrying amount and remaining amortisation period of any individual intangible asset that is material to the enterprise as a whole.
- The company should also disclose the amount of research and development expenditure recognized as an expense during the year.

***The ideal accounting practice regarding IPR can be summed up as follows:***

**Acquired IPR:** In the case of an acquired IPR, the money paid by the purchaser should be credited to the Bank Account while the IPR Account (Intangible asset account) should be debited. But, like every type of asset, an IPR also has a life span. It expires after a certain period. So the number of years left for its expiry can be used to write it off in equal installments through the Profit and Loss Account.

For example, if patent for a watch bought for Rs.10,00,000 by Titan Industries has a life of 10 years left, 10,00,000/10= Rs.1,00,000 should be charged every year to its P/L Account. The similar sum should be deducted from the value of the asset shown in the Balance Sheet as per double entry system of accounting. However, being an intangible asset, this process should be called Amortisation and not Depreciation as in the case of tangible asset.

**Self-developed IPR:** No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred. However, in case of developed IPR, the enterprise should demonstrate the existence of a market for the output of the IPR or the IPR itself or, if it is to be used internally, the usefulness of the IPR. Then only, it should be recognised as an asset. In case of self-developed IPR, the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset is important and its ability to measure the expenditure attributable to the intangible asset during its development should be reliable. However, in case of such capitalization of such an IPR, the number of years left for its expiry can be used to write it off in equal installments through the Profit and Loss Account.

**It has been seen over the years that the initial assumptions regarding an asset always do not hold true. Its life-term may change and so also its expected earnings potential. Hence every year the IPR should be tested for impairment as per the relevant Accounting Standard and the changed value should be taken into account.**

## Some Indian Practices

The following part takes a look at how some Indian companies value and account for their IPRs in the books of accounts. The information provided below has been sourced from annual reports and websites of the selected companies and hence is limited to the extent of the information published.

a) Sonata Software Limited (SSL)

SSL, along with its subsidiaries, is into software product development, providing technical support and consultancy services. The rights on the software developed constitutes its IPR. The company values software products developed or under development at cost. The cost of development of a self-developed software product is amortised over a period of three years or less based on the managements' evaluation of expected sales volume and duration of the product's life cycle.

[*Source : Annual report, Sonata Software Ltd, 2003-04, p. 25*]

b) ITC Limited (ITCL) :_ITCL, along with its subsidiaries, is primarily into production and selling of cigarettes and followed by lifestyle retailing, greeting cards, packaged foods, paperboards, hotels and packaging. Its IPR includes trademarks like "Wills" and "Kitchens of India" that it has self-developed and "mint-o" that it has purchased during the financial year 2003-04. They are amortised over a period of ten years. All expenditures made on capital assets required for Research & Development work are included under Fixed Assets and depreciated accordingly. All revenue expense of the R&D department are written-off through the Profit & Loss account.

[*Source: Annual report, ITC Limited, 2003-04, pp. 55,75*]

c) Asian Paints Limited (APL)

APL is in the business of paints and related chemicals. It expended a total of Rs.6.93 crore in R&D during the year 2000-01 which represents 0.55% of its total turnover. Capital expenditure on R&D is shown separately under respective heads of fixed assets while revenue expenses are charged to the revenue account

for the year. Know-how related to plans, designs and drawings are capitalized under relevant heads. Know-how developed related to manufacturing process is expensed in the year in which it is incurred.

[*Source: Annual report, Asian Paints Limited , 2000-01, p. 37*]

d) BASF India Limited (BIL)

BIL is in the business of leather chemicals, crop protection chemicals, textile chemicals and plastics. It expended a total of Rs.1.37 crore in R&D during the year 2000-01 which represents 0.3% of its total turnover. Capital expenditure on R&D is shown as an addition to fixed assets in the year in which it is incurred. Revenue expenses are charged to the Profit and Loss account. The company mainly imports know-how from its German parent.

[*Source: Annual report, BASF India Limited , 2000-01, p. 29*]

e) Bajaj Auto Limited (BAL)

BAL makes scooters, motorcycles and three-wheelers. It expended a total of Rs.42 crore in R&D during the year 2002-03 which represents 1.02% of its total turnover. Capital expenditure on R&D is shown as an addition to fixed assets while revenue expenses are charged to the revenue account. The expenses made to acquire technical know-how is amortised over a period of six years. The payments made to outside agencies for R&D work is charged out up to the stage of completion.

[*Source: Annual report, Bajaj Auto Limited , 2002-03, p. 106*]

f) Ceat Limited (Ceat)

Ceat makes automotive tyres, flaps and tubes. It expended a total of Rs.1.04 crore on R&D during the year 2002-03. Revenue expenditure is recognized as an expense in the year in which it is incurred. Capital expenditure on R&D is treated as an addition to fixed assets and is depreciated at applicable rates.

[*Source: Annual report, Ceat Limited , 2002-03*]

g) Glaxo Smithkline Pharmaceuticals (India) Limited (GSPL)

GSPIL manufactures pharmaceutical products. It expended a total of Rs.3.54 crore on R&D during the year 2003 which represented 0.30% of its total turnover. Capital expenditure on R&D is written off over the useful lives of the assets. Revenue expenses are recognized as expenses in the year in which they are incurred.

[*Source: Annual report, Glaxo Smithkline Pharmaceuticals (India) Limited, 2003*]

h) Hindustan Lever Limited (HLL)

HLL manufactures FMCG products, chemicals, fertilizers etc. Capital expenditure on R&D is shown as an addition to fixed assets while revenue expenses are charged to the Profit and Loss account of the year. The trademarks acquired after 01/01/1998 are amortised over a period of four years. Other intangible assets are written off in the year in which it is incurred.

[*Source : Annual report, Hindustan Lever Limited , 2002*]

The above examples help to highlight the fact that the Indian companies are yet to follow the standards as prescribed under AS-26.

## Conclusion

The twenty-first century will belong to those companies who will be able to leverage the power of knowledge in the most efficient way. And this does not refer only to the Information Technology companies. Even companies working in the field of industrial chemicals to iron and steel need to have some kind of IPR to survive in the modern world. So proper valuation of these IPRs have become an urgent requirement. And only when the value is just, we can properly account for the same in the books of the companies.

However, the present system of reporting of IPRs in the books of Indian companies is inadequate as exemplified in the case of ITC Limited and Sonata Software Limited. They seem to be confused on how to treat and leverage upon these IPRs in their books of accounts so that they can present a better picture of themselves in particular and of the Indian IPR in general. The above article attempts to serve as a road map for the Indian companies on how they can value and account for their IPRs – whether self-developed or acquired. This will not only help to present a "*true and fair view*" of their books at the end of the period, but also help them to sell or lease out its IPR at the correct price. ■