



Intangible assets and SMEs

REPORT OF THE ACCA SEMINAR HELD FEBRUARY 2007



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We deliver our qualifications in partnership with many organisations. We operate 18 joint examination schemes with national bodies around the world and work closely with 470 registered tuition providers and nearly 8,500 employers of accountants and finance professionals. We aim to support our students and members throughout their careers, delivering services through a network of nearly 80 offices and centres.

We use our expertise and experience to work with governments, donor agencies and professional bodies to develop the accounting profession. We aim to achieve and promote the highest professional, ethical and governance standards and advance the public interest.

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Introduction

Intangible assets underpin an increasing number of small businesses' competitive advantage and future earnings, and they help to create the uniqueness that is characteristic of the UK's SME community. Yet little research exists that explores the issue of SMEs and intangible assets. ACCA together with the Department of Trade and Industry and the Intellectual Property Institute have attempted to fill this gap and have commissioned Dr Chris Martin to conduct a major piece of research into the issue. The research, published in December 2006, offers a unique insight into the way SMEs create, value and protect their intangible assets .

In February 2007, over 80 experts and interested parties gathered at the Department of Trade and Industry conference centre to discuss the issue of intangible assets and SMEs. The delegates, drawn from SME representative organisations, intellectual

property professionals, financiers, government officials, accountants and other business advisers, were invited to join workshops that discussed a range of topics relating to intangible assets in SMEs. The seminar covered a broad range of topics including how SMEs use the formal intellectual property system, how advisers can support SMEs' intangible assets and the use of intangible assets for accessing finance.

A clear consensus emerged from the discussions about the importance of these issues to both SMEs and the wider UK economy, and that this importance will inevitably grow over the years. It is therefore imperative that all parts of the SME community, especially the support community, cooperate to understand, create and protect SMEs' intangible assets. This publication is a summary of the more detailed recommendations arising from the seminar discussions.



SME intangible assets, ACCA research report no. 93, by Martin and Hartley (2006) is available in PDF from www.accaglobal.com/research

When and how do SMEs make the best use of formal intellectual property?

Rapporteur: Dr Paul Leonard, Director, Intellectual Property Institute

The formal intellectual property (IP) system is what underpins the protection of many intangible assets, yet it is often poorly understood or used by UK SMEs. Broadly, the formal intellectual property system includes the rights conferred by patents and trademarks, and to a lesser extent design and copyright. In the modern knowledge-based economy the use of the UK and global IP protection systems is increasingly important, and this importance will inevitably grow. Ensuring that UK SMEs are getting ‘best use’ of the formal IP system is therefore of paramount importance for UK competitiveness.

An all-encompassing effort from the public sector and private sectors to educate the SME community on the formal intellectual property system is necessary. This effort will improve the understanding and use of formal intellectual property rights in the UK. The initiative must cover three broad areas:

1. training of SMEs to appreciate the risks, exposures and opportunities that the intangible assets created by their businesses present
2. education of owner-managers to improve their awareness of the rights and obligations conferred by the different forms of intellectual property and
3. training to enable SMEs to use the IP system in a cost-effective and efficient manner, including encouraging them to use ‘canny’ behaviours, such as securing and protecting assets in the territories in which they are likely to operate, or by taking out insurance.

There is also a need to increase the knowledge and understanding of IP within the general business-advice landscape. The public sector and professional institutions must ensure that business advisers, such as accountants, are able to recognise when SMEs require expert advice on IP matters and are able to refer SMEs to sources of that expert advice.

In addition, organisations that provide business-planning tools should include IP planning as part of the package, analysing owner-managers’ potential future requirements, risks and exposures.

Are there particular intangible asset issues associated with creative-industry SMEs?

Rapporteur: Mark Gold, ACCA Council member and Partner, Silver Levene

The creative industries, including such diverse activities as advertising, architecture, crafts and music, united by a common foundation of individual creativity and imagination, are an increasingly important sector of the economy. In the UK the creative industries will soon account for 10% of the economy; this sector is growing at over three times the rate of the rest of the economy (9% a year compared with 2.8% a year). Yet creative businesses often face specific challenges.

It remains very simple for malicious individuals to produce replicas of original products, particularly those of the television, music and fashion industries but also those of design and other creative companies. A vigorous law-enforcement regime with prosecution of the producers of pirated goods will benefit both large and small creative companies.

The public and private sector business-support organisations must encourage creative businesses to

foster a more 'business-like' mindset and maximise the exploitation of their intangible assets. This will result in a more profitable and less ephemeral sector.

The current intellectual property system in the UK is too costly and too complicated for small creative companies to exploit. The IP system should be made simpler, more flexible and more affordable; enabling the creative industries to claim their rightful royalties and be adequately rewarded for their creativity.

What particular intangible asset issues arise when SMEs are transferred to new owners and how can these issues be addressed?

Rapporteur: Dr Chris Martin, Chris Martin & Associates and author of ACCA research reports Accountancy Practices and the Provision of Ownership Succession Advice and SME Intangible Assets

The exit of SME owners from their businesses and transfer of these businesses to new owners are issues that are too often ignored within the business life cycle; much rhetoric is expended on start-up and growth but little on exit. Listed companies have well-established markets facilitating the transfer of ownership. This is not the case for unlisted businesses, particularly SMEs. Ensuring that business owners are able to transfer a strong and viable business to a new owner prevents job losses and maintains efficient markets, which is critical to the economy as a whole. A growing number of SMEs have a significantly large proportion of intangible assets, and these are essential to the success and continuing profitability of such firms. The lack of physicality of intangible assets adds to the problems of exit and transfer.

It is important to recognise that while many intangible assets can be transferred to a new owner, on some occasions the process may be problematic. For example, the transfer of assets that are inextricably linked to the owner poses problems. In such cases it is important for the buyers and sellers to examine strategies that address the problem of transfer; for example, an earn-out scheme. It is important that business advisers are used as a source of guidance to owners in developing such strategies.

In order to ensure the successful transfer of SME intangible assets, the SME must take steps to 'strengthen' individual intangible assets. This can be done through formalising customer agreements, documenting processes, exploiting the registered rights available and taking appropriate advice. This process is often not the first priority in the minds of owners preparing for exit and transfer and so there is role for government and the private sector to improve the awareness of the need to complete these activities.

Impetus must be given to developing an accepted valuation methodology and to stimulating intangible asset markets. Currently the UK has no recognisable market for many SME intangible assets. This, coupled with the lack of an accepted methodology for valuing intangible assets, causes significant problems in their valuation and transfer. Often there is a significant variance between the value placed upon the intangible assets of a firm by the buyer and the seller. In order to circumvent these difficulties, valuation experts analyse the recurrent income of a firm and use sector-specific multipliers to arrive at a value that encompasses some, though not all, of a business's intangible assets. It is unlikely that this method, while the most effective method at present, will remain satisfactory in an increasingly knowledge-based service economy such as the UK's.

Accessing finance

What are the issues in valuing SME intangible assets as a basis for accessing and raising finance? How can these issues be addressed?

Rapporteur: Richard Simmons, Entrepreneur, RDS Change and Solution Ltd.

There is evidence that the vast majority of SMEs, in general, do not face significant problems accessing finance, but some companies may face such problems. These are invariably businesses that offer the highest growth possibilities, and so these weaknesses have a disproportionate impact on the general economy. Typically, these businesses have a greater reliance on intangible assets.

Entrepreneurs with established high-growth businesses seeking to develop businesses with many intangible assets but few tangible assets face significant problems accessing finance, particularly debt finance. Despite efforts by the UK government and the European Union (EU) to help entrepreneurs whose asset base is mainly intangible to access debt finance, there still remain significant gaps, especially in the provision of debt finance for rapidly growing companies. The UK government and the EU must continue to search for solutions to address the funding gap for businesses whose asset base is mainly intangible.

When entrepreneurs seek equity finance in the form of venture capital, the venture capitalist will generally take an overall view of the enterprise's value, taking into account intangible assets such as management and customer systems, patents, technical know-how, product innovation and branding. Compared with the US, however, the UK and Europe's venture capital markets are underdeveloped. Several reasons relevant to intangible assets were suggested to explain this disparity. For example, funds in the UK's venture capital market are not large enough and their managers

are not knowledgeable enough to make the best investment decisions, particularly when dealing with smaller companies that are in new and cutting-edge technologies with a high reliance on intangible assets. There is therefore a need for venture capital fund managers to focus on a niche and portfolio approach to their investments, working with appropriate knowledge resources to make the best decisions and obtain the highest returns.

Research suggests that in the UK, SMEs with a turnover of between £250,000 and £5,000,000 are often unable to access finance from any source. This gap in the availability of finance prevents the creation of additional wealth and employment. Equity finance is not appropriate in these circumstances as current investors are keen to avoid the premature dilution of their equity holdings. The most effective way to diminish the impact of the finance gap in these circumstances is to establish mezzanine finance funds that provide mixed finance to SMEs. Mezzanine finance makes an important contribution to technology funding in the US and similar public sector intervention is required to address the gap that exists in the UK today.

How can accountants and business advisers best assist clients to develop intangible assets as part of building businesses of value?

Rapporteurs: Tony Cushing, ACCA Council member and Partner, Moore Stephens; and Peter Weeks, Business Adviser, Business Link

Business advice is normally provided to assist in the management of a firm so as to promote business prosperity and assist the firm to comply with, and demonstrate compliance with, statutory obligations. Within the UK, research has consistently found that the external accountant is the most frequently used source of business advice. A number of studies have suggested that over 95% of UK SMEs receive some form of external business advice. It is clear that business advisers, and in particular accountants, can play a key role in improving awareness and in development of SMEs' intangible assets. There are a number of barriers that currently hinder the provision of assistance in this area.

SMEs currently do not demand advice on intangible assets owing to a lack of awareness, among owner managers, of their importance to the business. Advice is only requested when specific intangible asset related issues arise during a transaction such as a business transfer, and this is often too late. Companies should be encouraged to protect and develop their intangible assets from an early stage.

Accountants and other small business advisers should be provided with comprehensive continuing professional development opportunities in all aspects of SME intangible assets. Advisers need to be able to help SMEs identify their income streams and then link each stream to an intangible asset or a cluster of intangible assets. Further learning opportunities for advisers

exist across the issue of intangible assets. ACCA is pioneering work in this area with a number of relevant courses, and other bodies should be encouraged to provide specific training on this issue.

The public sector, working with relevant institutions such as ACCA and the Intellectual Property Institute, should look at ways of developing a signposting scheme whereby advisers are able to recognise when an SME client should seek specialist advice on its intangible assets and can then direct them to the appropriate source of specialist advice. Any such scheme should be delivered through existing support relationships, complementing and bringing them together, rather than replicating existing activities.

What are the relationships between innovation processes and intangible assets?

Rapporteur: Professor Keith Dickson, Brunel Business School

Ensuring the economy's continuing prosperity and improving productivity is a priority for most governments. These objectives can be met by increasing and encouraging innovation among the business community. This method is particularly important for the more developed economies, which have less scope for growth based on 'capacity building' and for cost competition.

Many policy instruments have been developed to encourage innovation; in the UK the most obvious mechanism is the Research and Development tax credit. This credit enables businesses that spend money on R&D to reduce their corporation tax bill by up to 175% of the qualifying expenditure. Yet few policy interventions have addressed the issue of intangible assets and innovation, particularly the relationship between the two. Government ought to take stock of policy interventions to date and consider whether a specific measure is needed that addresses the relationship between intangible assets and innovation.

It is imperative that a methodology is developed that values intangible assets so as to promote innovation within firms and the economy as a whole. One of the existing problems when addressing intangible assets created through innovation is that they are not recognised in the balance sheet. The result is that the

users of the financial reports, such as banks making lending decisions and owner-managers who manage the intangibles, fail to recognise these assets. This acts as a disincentive for firms to innovate and create intangible assets; it also means that firms are not being adequately rewarded for their innovation.

Methods that strengthen the intangible assets and separate the innovation process from the owner ought to be developed. The inextricable link between the owner-manager, the innovation process and the subsequent intangible assets generated is a significant issue for smaller firms and their innovation. This interdependency can hinder further growth of businesses and the transfer of ownership. This ought to be addressed through the promotion of standard documentation, the adoption of clearer processes and the use of methods that strengthen intangible assets, such as the formal IP system or formal agreements with customers, suppliers and employees.

Higher education institutions

What is the role of higher education institutions in encouraging SME innovation and the development of intangible assets?

Rapporteur: Dr Emma Baron, Business Development Officer, Newcastle University

SMEs' awareness of intangible asset and innovation issues is relatively low. This lack of awareness will have a detrimental effect on the country's economy, as it becomes more reliant on intellectual capital and intangible assets. The rationale for universities to involve themselves in this topic is not simply economic benevolence. In order to attract future students, higher education institutions must have a reputation for producing graduates who are equipped for the modern world of work and be employable.

There should be greater recognition of the role that universities, as key knowledge brokers in modern economies, can, should and do play in improving SME awareness. Higher education institutions (HEI) play a significant role in supporting SMEs, particularly the more high-tech businesses. Government and other SME stakeholders should therefore make greater efforts to use universities as a valuable resource.

At the same time, there is a clear incentive for HEIs to put themselves at the forefront in -encouraging SMEs to be more innovative and to develop their intangible assets. HEIs ought to act in a proactive and innovative manner to ensure that each scheme meets the needs of the SMEs. For example, the organisation of sector-

specific briefings can bring SMEs together and help improve awareness of the issue.

Universities should foster more practical and intensive schemes, such as providing students to SMEs, which would give valuable business experience to the students as well as academic expertise to SMEs. These broker schemes need not be limited to students; academics could also be offered as consultants for SMEs, particularly when offering specialist expertise for specific sectors of SMEs. The mutual benefit of such schemes has already been recognised in some parts of the country (such as Business Link South East) and best practice case studies ought to be identified and promoted widely to universities in other regions.

What are the particular issues for SMEs in valuing and managing their knowledge and information resources?

Rapporteur: Professor Harry Scarborough, Warwick Business School

SME owners need help to build knowledge strategically into their business in order to achieve success. They often do not understand or recognise the information assets they have, and make little time to reflect on the effectiveness of processes they may already have in place that could help ensure that the information and knowledge they own add value to their business. Small businesses need to make greater efforts to handle the management of information, as an intangible asset, in a systematic way. Unlike larger businesses, small business owners often keep vast stores of useful information in their heads, and these stores are not shared; nor do they encourage the development of processes or systems that would facilitate more effective management of information. These can cause significant problems for the growth and development of a firm.

There should be greater activity in raising awareness of the benefits of strong information and knowledge-management systems, structures and processes. These systems help SMEs turn learning into intangible assets, for example through innovation and development of new services. Greater awareness of this would encourage SMEs to make more effort in recognising the value of their information assets, especially when they learn that they may be of value to someone else. The research community must provide models of best practice, giving examples of what has worked, where, and how to aid the awareness-raising activity.

Practical guidance and training should be provided to SMEs to enable them to understand the contribution to the firm of information and knowledge-related assets, at a human and structural-capital level. Owner-managers need greater understanding of how their information resources (eg for information collection,

creation, maintenance, sharing and protection) can be made to work most effectively for their organisation and what their organisation's key social and knowledge-sharing networks are. They need to appreciate that they must be more effective at information management than their larger competitors, because they have fewer resources.

In this age of information overload, SMEs need targeted, tailored advice on where to get help, what information-related advice is relevant to them and what they need to do to protect and control their information-related assets. Advisers such as accountants, who deal with SMEs on a day-to-day basis, would benefit from an aide-memoire to help guide the management, measurement and/or valuation of intangibles. This aide-memoire must include a section on information and knowledge resources and their management.

ACCA Small Business Unit

ACCA represents over 50,000 professional accountants in the UK and 56% of our members work in or for a small business. We have over 100 years' experience of working with and providing professional advice to small and medium-sized firms. ACCA's Small Business Unit works to promote the growth of small businesses in three critical areas: financing the small firm, helping them to handle regulation and business support.

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