Chapter VI
The Financial Valuation of Intangibles:
A Method Grounded on an IC-Based Taxonomy

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ABSTRACT

This chapter proposes a method for the financial valuation of intangibles based on a specific taxonomy that distinguishes between intangible assets and core competencies, while classifying the latter into (tangible or intangible) asset-driven core competencies and non-asset driven core competencies. The method proposed is based on the assumption that the value of a company’s intangibles is to be found essentially in its core competencies. Financial valuation models based largely on the cash flow generated by the company and on real options valuation are proposed as a means of identifying and quantifying a company’s intangibles in monetary terms, taking the earnings they are capable of generating into account. This method is suitable for valuing the intangibles of large companies and smaller businesses where large databases are not available.

INTRODUCTION

This chapter proposes a method for the financial valuation of intangibles based on a specific taxonomy that distinguishes between a company’s intangible assets and core competencies as value drivers. Our approach assumes that the value of a company’s intangibles lies essentially in its core competencies.

Based on a strategic analysis that identifies the firm’s core competencies and assets, the proposed method also singles out the characteristics contributing most to the generation of value.
Financial valuation models based largely on the cash flow generated by the company and real options valuation are proposed as a means of measuring the value the business receives from individual intangibles. The company’s financial information and the analysis and opinions of its directors are employed in implementing these models. The method is suitable for valuing the intangibles of large companies and smaller businesses where large databases are not available.

The second section looks into the basic concepts for the financial valuation of intangibles, and provides a critical survey of the approaches and models developed to perform this valuation.

The third section provides a discussion of the method’s basic concepts and characteristics. The fourth section describes the initial stages of the method, designed to obtain the information needed to ascertain the value of a company’s intangibles.

The fifth section shows how, in the context of this method, financial valuation models can be applied to obtain the value of a firm’s intangibles.

The sixth section sets out the method’s future development prospects.

The conclusions, which summarize the results obtained, are followed by a short bibliography.

BACKGROUND: THE FINANCIAL VALUATION OF INTANGIBLES

To begin with, this section looks at the basic concepts for the financial valuation of intangibles, and then provides a critical survey of the approaches and models developed to perform this valuation.

Why Value a Firm’s Intangibles?

The management and valuation of companies’ intangible resources and assets is undoubtedly a major preoccupation. This is particularly true of knowledge-based assets, also known as intellectual capital (IC) (Hussi, 2004; Kaufmann & Schneider, 2004).

A company’s intangible assets often account for a greater proportion of its overall total assets than its tangible assets do. However, the value of most intangibles does not appear on the financial statements, largely because the lack of transparency and the absence of a benchmark market make it difficult to value them (Lev & Zarowing, 1998).

Some authors see no need for explicit reports on the value of the companies’ intellectual capital, arguing that the market already does this by valuing their securities. This view would be correct if the stock market were continuously efficient, but this has proven not to be the case. But the market always values the set of a firm’s intangibles, which means the problem of valuing them individually persists. Furthermore, stock market valuations are not applicable to unquoted SME, comparable listed companies being hard to find.

Demands from the corporate world prompted academic research in the 1990s into ways of reflecting the value of intangibles in financial statements (García-Ayuso, Monterrey, & Pineda, 1997; Lev & Zarowin, 1998; Lev, Sarath, & Sougiannis, 1999; Lev, 2001b; Cañibano et al., 2002). Unfortunately, the problem has largely resisted efforts to find a solution.

The lack of an explicit valuation of intangible assets may encourage information asymmetries and inefficiencies on stock markets. Experience shows that when the value of intangible assets is included in the market analysis, forecasts on the future business performance improve, which highlights their importance in making the market efficient, reducing information asymmetries and thus the risk of adverse selection.

Apart from the advantages for financial market performance to be gained from fuller information about a firm’s intangibles, detailed knowledge of such intangibles inside the company is also very important:
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