Valuation of Intangibles for Transfer Pricing Purposes: Convergence of Valuations for Transfer Pricing Purposes with Valuation for Other Purposes

Presentation to Working Party No. 6 of the Committee on Fiscal Affairs by:

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Context

Our presentation is made in the following context: We discuss valuations performed for TP purposes relative to valuations performed for “other purposes” where we define “other purposes” to principally refer to valuations performed for accounting standards purposes (either IFRS or US GAAP, hereafter we will only reference IFRS).1 We will focus our remarks on the application of the income method of valuation or the Discounted Cash Flow (“DCF”) approach since experience suggests that this is the most widely relied upon approach applied in performing TP valuations and is also frequently one of the methods relied upon in performing IFRS-related valuations.

Is there really a full convergence of TP and other valuations?

Despite the fact that the title of this session suggests there may be a convergence between valuations done for TP purposes and those done for IFRS purposes, we think the situation is more nuanced. While there can be a convergence in some circumstances, more often than not there will be a material difference.

Comparing the “fair value” standard under IFRS 3 (“(t)he amount for which an asset could be exchanged or a liability settled, between knowledgeable willing parties in an arm’s length transactions”) with the arm’s length standard as defined under the TPG, we believe it is reasonable to conclude that the two standards are very consistent, if not identical. Thus, the lack of convergence does not arise from any fundamental difference in the stated objectives of the TP and IFRS valuation exercises.

Where the difference arise and why a valuation performed for TP purposes does not necessarily always converge to a valuation performed for IFRS purposes is due to differences in the way the DCF method is applied in performing a TP valuation, particularly differences in the definition of key parameters applied in the analysis. Thus, DCF valuations performed for TP purposes may provide little information for the determination of the fair value of the intangibles assets involved in the inter-company transactions for balance sheet purposes considering the accounting standards. Meanwhile, some valuation methods frequently relied upon for accounting standards and corporate finance purposes cannot be reliably applied for transfer pricing purposes.

Why TP and IFRS valuations do not necessarily converge – (1) the TP side

Some of the more important reasons TP valuation results and IFRS valuation results do not necessarily converge are the following:

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1 There is increasing converge between IFRS and US GAAP.
First, transfer pricing valuations frequently involve transactions for unique intangibles that would not be transacted between unrelated parties. Entity A sells a unique and valuable bundle of rights and/or know-how to Entity B under circumstances where no unrelated party would likely be given the same access to the same grouping of rights and/or know-how. This uniqueness of the transactions engaged in on an inter-company basis frequently translates into relying upon the DCF as the most reliable method to apply under the TPG. Market comparables simply do not exist for the same set of intangibles nor would a cost approach (cost to replicate) be reliable.

Second, the TPG recognizes at paragraph 6.2 that there may be valuable intangibles that are transacted inter-company “even though they may have no book value in the company’s balance sheet.” This is important in the context of recognizing that TP valuations of intangibles and corporate finance valuations which seek to value intangible assets for balance sheet purposes do not necessarily define the same type and grouping of intangible assets to be valued.

Third, TP valuations frequently involve closely linked transactions that cannot be considered separately in performing a valuation for TP purposes. This point ties to applying TPG paragraph 3.9 regarding evaluating transactions that are so closely linked that they cannot be evaluated adequately on a separate basis. This circumstance frequently creates a distinctive analytical framework for TP valuations.

Fourth, adding to the guidance of paragraph 3.9, the TPG indicates that a transaction must be considered in its entirety to determine if the condition stated at paragraph 9.59 is to be met² – that is, the TPG seeks to compare the “as is” situation to the other option or options available. Would Company A enter into the deal with Company B – this can only be determined by considering all of the components of the transaction simultaneously or what paragraph 6.17 of the TPG calls a “package price.” This package price or bundling approach reflects a different philosophy from the one applied in performing IFRS valuations which seeks to identify the assets separately and value them separately. TP valuations consider the net result on a present value basis – is A as the seller at least as well off or better off considering the transaction – the “package deal” -- in its entirety? The package deal may need to include a “balancing payment” that is determined by the netting of the present values of the other closely linked transactions. The balancing payment would ensure that the package deal result complies with the guidance of paragraph 9.59 – the seller is at least as well off making the deal relative to the “as is” situation. The value of the balancing payment is more often than not different from the fair value of the intangibles included into the package deal. This is a one important distinction between TP valuations and those done for IFRS purposes.

Fifth, TP valuations should be based on considering pre-tax income (typically operating income when it can be reliably determined) or cash flows.³ (See Figure 1.) (This conclusion is supported from the TPG discussion of the proper application of the TNMM; for instance see Chapter II, paragraph 2.62 reference to operating income). A comparison of the package deal results pre- and post-deal for the seller of a bundle of intangible assets should consider its pre-tax operating income results independent from the degree of the seller’s financial leverage (again like in the TNMM context) and tax position. That is, TP valuations do not necessarily need to consider either element directly in arriving at the arm’s length valuation. On the other hand, an IFRS valuation is commonly considered to be based on the present value (PV) of post-tax cash flows – in this regard it seeks to determine the market value for the intangibles possessed by an entity for balance sheet purposes considering both tax and financial leverage conditions of the owner of the intangibles.

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² This condition also appears elsewhere in the TPG; to simplify we only mention this single reference.

³ Some practitioners rely upon determining the PV of post-tax cash flows and then gross up to the pre-tax level.
Sixth, TP valuations are rarely made to determine the going concern value. More often than not, a TP valuation is done for a piece of a business (or set of identified intangibles) within a larger enterprise or legal entity. (See Figure 2.) Nor do TP valuations need to necessarily separately value certain assets of the business which are commonly valued in IFRS/corporate finance valuations; for example, the value of the existing work force is often valued as a separate asset. There can be other adjustments performed in corporate finance valuations such as the price paid for control of a business, etc., that are not routinely considered in the case of TP valuations. Nor is the TP valuation necessarily directly concerned with goodwill. The treatment of goodwill into the context of a TP valuation will depend on the context that gives rise to the goodwill in the IFRS valuation thus must be considered on a case-by-case basis.

More commonly in the case of TP valuations, the value of the constituent pieces of the total business are often subsumed in a TP valuation to the splitting of the overall results between ordinary (including routine intangibles such as the value of the existing work force) and what the functional analysis of the business identifies to be the potentially high value, non-ordinary intangibles. (We note that in the WG No. 6 scoping paper the definitional questions were posed; we do not address them here.) Thus, TP valuations, in general, are not as granular as IFRS valuations nor should they be in order to reliably determine an arm’s length result for the valuation of the specific intangibles included in the scope of the package deal transaction.

Lastly, there is the issue of the appropriate parameters to apply in the DCF analysis. First, what is the appropriate discount rate(s)? Second, there is a question of defining the terminal value (TV) – this relates to the useful economic life of the assets being valued. Often, but not always, IFRS valuations of going concerns will apply an assumption of perpetuity in determining the TV. This may not be an appropriate assumption for performing TP valuations. We discuss the discount rate and TV issues further below.

Taken together, for these reasons above, a TP valuation will frequently not converge to a same result as one obtained under IFRS and corporate finance valuations. To illustrate, take a circumstance commonly found in the TP valuation context but which is not commonly found in the IFRS context. Referring to Figure 2, assume a situation where pre-restructuring there is an operating division with an intangible development function (IDF), R&D in this case, performed in legal entity A; it performs this function on its own behalf and bears all costs associated with the IDF; assume that legal entity Company B then seeks to acquire A's intangible assets (know-how, patents, trademarks, etc.), B agrees to compensate A’s ongoing IDF costs (with a mark-up), while A then pays B an arm’s length royalty for the right to use the intangibles. The restructuring of A’s R&D activity must be considered in its entirety as a package deal to determine if the condition stated at paragraph 9.59 is met – compare the “as is” situation to the other option. What amount should B pay to A considering the package that would entice A to enter into the new arrangement? This can only be determined by simultaneously considering the net PV of the three components of the package deal: a) the payment for A's R&D costs (considering A is a contract R&D service provider and will no longer bear the cost and risks associated with performing R&D); b) the royalty to be paid by A for a license from B; and c) the balancing payment paid by B to A that makes A economically at least as well off by accepting the package deal compared to the “as is” conditions (considering risks borne and functions performed).

The value of A’s R&D intangibles for transfer pricing purposes is not considered on a standalone basis since it is only considered in the context of the package deal. This means that the value of the balancing payment made to achieve an arm’s length result is very unlikely to be the same as the fair value of the same intangibles valued on a standalone basis for IFRS purposes. Based on our experience, there does not seem to be a general consensus in the auditing community on how to reconcile this difference, if at all.

**Why TP and IFRS valuations do not necessarily converge – (2) the IFRS/corporate finance side**

Corporate finance valuations including those performed under IFRS frequently use multiple methods to define a range for the potential value of each category of tangibles and then identifies a point in that range which the analysts determines, considering all of the information evaluated, as the most reliable estimate for balance sheet purposes.
One approach applied under IFRS 3 is to compute a Weighted Average Return on Assets (WARA). The WARA method is used as a confirming approach when goodwill is identified as part of a Purchase Price Allocation (PPA) exercise. The WARA approach seeks to approximate discount rates for discrete categories of assets (cash, inventories, receivable, etc.). However, this approach relies on the book values of assets, which is problematic for two reasons. First, many intangibles, including many of those requiring valuation for TP purposes, are not included on the balance sheet because they were never acquired from an external party. Second, in order for this approach to fit with finance theory, one would need to complete the exercise using market values for all categories of assets, which is almost never available. Third, even if it were possible to determine an appropriate discount rate for intangibles from the balance sheet, it is not at all certain that the same discount rate would apply to all intangible valuations for TP purposes. For example, the need may arise to evaluate intangibles that are fundamentally more risky than those on the balance sheet, and correspondingly a higher discount rate would be needed than that predicted by the WARA method.

In traditional corporate finance valuation exercises a multiples approach is commonly applied for valuation of the going concern. This approach focuses on valuing an entire company with publicly available comparables’ data. Using some form of the adjusted present value (the value of the unlevered firm plus the tax shield) would be appealing but relies on an estimate of the return on the market value of assets, the same problem encountered with the WARA.

As discussed above, the discounted cash flow method remains the most commonly applied approach for corporate finance valuations. The discount rate used is obviously an important parameter. We discuss this in detail in the following section because there is a fundamental difference in the discount rate that should be applied in a corporate finance valuation relative to a TP valuation.

There is one area where valuations for IFRS purposes and TP purposes can overlap. This is in the circumstance of a merger or acquisition where a PPA is performed under IFRS (per IAS 36 and IAS 38 – these standard relate to determining the value of goodwill and intangible assets). The PPA identifies and then values for balance sheet purposes different types of assets (including tangible assets) acquired, including goodwill. In some cases companies will want to transfer some of the acquired intangible assets from one legal entity to another post acquisition which requires making a valuation for TP purposes. We believe that the PPA can be in many cases can be a useful starting point to performing a TP valuation and thus it should be considered on a case-by-case basis with appropriate guidance on how to apply the results of the PPA in the TP valuation context.

We suggest that the revised Chapter VI guidance discuss the conditions under which the PPA can be considered reliable for TP valuation purposes including the type of adjustments to the PPA results that would be considered appropriate to improve the reliability of the PPA results for TP valuation purposes. In this regard, some concerns have been registered regarding relying upon the PPA results when goodwill is included in the PPA. The issue is whether the presence of goodwill might distort the value of the intangible assets under review for TP purposes. (This concern was evident in the revised U.S. temporary regulations regarding cost sharing, for example.) We suggest this point be carefully reviewed, but we do not believe the existence of goodwill makes it inappropriate to consider the PPA results as the starting point for the value of the intangibles considered for transfer.

**Appropriate definition of the discount rate to be applied for TP valuations**

As explained above, TP valuations are related to comparing pre-structuring operating income (or cash flows) to post-restructuring operating income. It can be shown that TP valuations relying on determining the PV of pre-tax income cash flows should apply a post-tax discount rate. (The alternative is to consider post-tax results and then gross up the results to a pre-tax result.) Corporate finance valuations, on the other hand, typically focus on determining the PV of post-tax cash flows and then adjust, as necessary, the PV amount for the value of any tax shield.

It is important to acknowledge that finance academics are still not in agreement on the ways to calculate the appropriate discount rate in all instances, and therefore any revision to Chapter VI of the TPG, if it is to narrow the range of disputes on valuation of intangibles, should seek to try to provide some practical guidance around what is a very complex topic.
In this regard, we suggest the following as one possible practical solution: First of all the average cost of capital of the seller should not necessarily enter into the DCF computation. It is the acquirer’s cost of capital that is relevant – the acquirer needs to purchase the assets in the package deal such that it anticipates (based on the business projections made at that time of the acquisition) achieving a cost of capital return (properly adjusted for risk). (The acquirer’s tax status should also not factor into the valuation of the package deal.) In this regard there are published data available from reliable third party sources that provide industry average cost of capital values. Given the ongoing debate in the academic community on the appropriateness of different methodologies for the cost of capital, we would suggest adding an example in Chapter VI illustrating that a simple industry WACC can be applied. Relying upon this independent source of information to determine the WACC is analogous to using the public data bases to search for TNMM comparables and would reduce some of the complexity of reviewing the DCF computation results.

Then there is the issue of adjusting the post-tax WACC for the riskiness of the assets or cash flows that comprise the package deal. Standard finance principles indicate that a standalone asset or cash flow would have greater risk, hence it is appropriate to adjust the average industry WACC (which is for an enterprise) for the relative riskiness of the specific standalone assets and cash flows. Chapter VI should provide guidance on adjusting the discount rate for the relative riskiness of the cash flows that comprise the package deal consistent with the standard practices of corporate finance.

Another important parameter in the DCF analysis besides the risk-adjusted discount rate is the determination of the terminal value. In corporate finance valuations of going concerns the terminal value is often computed assuming a perpetuity growth rate. The perpetuity assumption, while appropriate for corporate finance purposes, is likely not to be appropriate in the context of many TP valuations where the intangible assets’ useful economic lives should be recognized as limited to a specific number of years (determined by an analysis of the specific facts and circumstances).

We would suggest that in revising Chapter VI it would be useful to consider the already accepted concept of applying a range to define the arm’s length result. A range can easily be accommodated into the DCF analysis framework by having the TPG suggest that critical parameters be identified and that the sensitivity of the overall valuation to variations in these critical parameters be indicated, including why a particular point in the range was selected as the most reliable considering the facts and circumstances. (Another way to consider this point is to recognize that the valuation of the intangible assets for TP purposes cannot be determined with certainty and that the “real” value lies within a range.)

Of course, it would be appropriate to have the TPG recommend that a TP valuation include information on the forecast relied upon, its source and purpose along with related information regarding the purpose of the restructuring. Varying the forecast assumptions could be done in the context of the sensitivity analysis defining the arm’s length range as mentioned above.
Some recommendations

Due to the way the TPG defines the practical application of the arm’s length principle, we explained why TP valuation results will frequently not closely align to the results for valuations performed for IFRS and corporate finance purposes. TP valuations by definition often involve a package deal consisting of multiple, closely linked transactions, including in some cases a balancing payment. The package of transactions is frequently undertaken in the context of a restructuring exercise. The existing version of the TPG at various chapters provides important guidance relevant to the TP valuation exercise. We would therefore suggest that revisions to Chapter VI consider synthesizing the various elements in the current version of the TPG that define the TP valuation framework. We would further recommend that the revised Chapter VI language include the notion of a reliably standard to reinforce the notion that not all valuation methods applied under IFRS or corporate finance can be reliably applied under the TPG considering the proper application of the arm’s length standard. This would clarify that a valuation based on applying the DCF method is not a method of last resort.

We would also recommend that there be practical guidance provided in Chapter VI on the specific application of the DCF method for TP valuations and, in particular, it should provide general guidance for the determination of the appropriate discount rates (adjusted for risk) to be applied and the terminal value computation (considering the economically useful life of the assets). In this context, we suggest that Chapter VI include a recommendation that TP valuations identify the key parameters that influence the overall valuation result and that a sensitivity range be provided (based on applying a sensitivity analysis varying the key parameters).

Lastly, we suggest that there be guidance regarding relying on the results of a PPA valuation exercise. Even when goodwill is identified in the PPA result (and more often than not it will be), the TPG should provide guidance on how the PPA results can be applied for TP valuations.
Figure 1:
Transfer pricing valuations are based on operating income

P&L of target (assume division)

Sales
  Less cost of sales (“COGS”)
  Less operating expenses
  Less depreciation & amortization
  Less R&D
  = Operating Income

Operating Income
  Less other non-operating expenses/net interest income
  Less taxes
  = Net Income (after tax)

Example:
profit split methods split
Operating Income

(1) USCo routine ➔ (2) non-routine

R&D USCo
R&D Non-USCo

Corporate finance valuations are based on adjusting net income after tax
Figure 2:
Illustration of difference in scope of common valuation performed for transfer pricing compared to scope of corporate finance valuations.