Valuation of Intangibles under IFRS 3R, IAS 36 and IAS 38

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Agenda

► Overview of Purchase Price Allocation under IFRS 3R
► Valuation of Intangibles - Approaches & Methodologies
► Impairment Testing (IAS 36) and Value In Use
► Questions
Purchase price allocation under IFRS 3R

Total Purchase Price

Intangible assets

Technology

Other Intangible assets

IPR&D

Research indefinite life until start of use

Capitalised and amortised

Capitalised - Amortised?

Capitalised and not amortised

Tangible assets

Developed Technology

Contracts

Customer Relationships

Trademarks

Goodwill

Total

Purchase Price

Valuation of intangibles: IFRS 3R, IAS 36, IAS 38
Common intangible assets

Marketing-related intangible assets
- Trade marks
- Internet domain names
- Non-competition agreements

Customer-related intangible assets
- Customer lists
- Order or production backlog
- Customer contracts
- Customer relationships

Artistic-related intangible assets
- Plays
- Books
- Pictures

Contract-based intangible assets
- Licensing, royalty agreements
- Leasing agreements
- Broadcasting rights

Technology-based intangible assets
- Patented and unpatented technologies
- Software
- Databases
- Secret formulas, processes
Basis of valuation under IFRS 3R

Issues to consider

Basis of valuation can influence the quantum of value:

► Fair Value is the basis of valuation for PPA purposes under IFRS 3R, which is defined as:

“...the amount for which an asset could be exchanged or a liability settled between knowledgeable and willing parties in an arm’s length transaction.”

► Fair Value under IFRS 3R can differ from “Fair Value” and “Fair Market Value” for legal and tax purposes.

► Relevance of actual parties in “market participant” context e.g. buyers specific vs. market participant synergies.
Valuation of intangibles (IAS38)

- **Market Approach**
  - Primary method under IFRS 3
  - “Quoted market prices in an active market provide the most reliable estimate of fair value”
  - IAS38.39
  - If no market exists, fair value could be based on similar arms’ length transactions

- **Income Approach**
  - “Discounting estimated cash flows from the assets or estimating the costs the entity avoids by owning the assets”
  - IAS38.41
  - Approach needs to reflect current transactions and practices in the industry to which the assets belongs

- **Cost Approach**

- ► Quoted market prices in an active market typically provide the most reliable estimate for the value of an asset.

- ► Only if the prerequisites of the market approach are not fulfilled, the income approach is applied. The cost approach is applied only if the prerequisites of neither the market nor the income approach can be met.
Market based approaches

- The market approach determines the Fair Value based on quoted market prices observed in an active market. An active market fulfils all of the following conditions:
  
  i. the items traded within the market are homogenous;
  ii. willing buyers and sellers can normally be found at any time; and
  iii. prices are available to the public.

- In practice, sales prices, especially for intangible assets, are rarely available since these are typically transferred as part of the sale of a business, not in piecemeal transactions.

- Because intangibles are often unique to a particular enterprise, a comparison between enterprises is often difficult.

- For these reasons, the market approach is seldom used and is rarely appropriate for the valuation of intangible assets.
Income based approaches

► The income approach is based on the assumption that the value of an asset is determined by its ability to generate future cash flows. The income approach involves two steps:

1. First, estimate the forecast net cash flows expected to accrue directly or indirectly from ownership of the asset or a group of assets; and

2. Second, the present value of the estimated future net cash flows needs to be determined by discounting.

► The discount rate is derived by reference to an observable capital market yield (e.g. a WACC).

► The income approach applies the following discounted cash flow methods which vary in the way future cash flows are attributed to the respective asset:

i. direct cash flow method;

ii. relief-from-royalty method;

iii. multi period excess earnings method; and

iv. incremental cash flow method.
Relief from royalty method

► The approach is based on the concept an owner of an intangible asset does not have to ‘rent’ one and is therefore ‘relieved’ from paying a royalty.

► In using this method, arm’s-length royalty or license agreements for comparable assets are analysed.

► The net revenue expected to be generated by the intangible asset during its expected remaining life are then multiplied by the selected benchmark royalty rate.

► The estimated royalty stream after tax is then discounted to present value, which results in an indication of the value of owning the intangible asset.

► IP ownership has to be considered as a bundle of rights or privileges divided among the licensor and the licensee and leads to the following equation:

\[
\text{licensor rights} + \text{licensee rights} = \text{trademark value}
\]

► These are the right to sell, the right to use, the right to transfer by contract some of the benefits for a period of time, etc.
Profit split analysis

A licensee is willing to enter into a transaction only if it can cover its expenses of doing business and can earn a reasonable return on the investment required.

Thus the licensee needs to retain a portion of the economic benefit of the licensed trademark. The licensee’s full economic benefit of the trademark is not paid over to the owner in royalties.

Profit Split Considerations:

i. Which level of profit should be selected?;

ii. Are there differences in business model between licensor and licensee?;

iii. Differences in regulatory environments/tax structures between licensor and licensee?; and

iv. Which margin should we split e.g. historic, short-term or long-term margin?

Issues to consider

Does the royalty based on a profit split provide a sufficient return on & of the intangible asset in question over its remaining useful life?
Multi-period excess earnings method

**Definition**

► The MEEM determines the value of an asset based on cash flows that are exclusively generated by the asset in question.

► Usually, intangible assets can generate cash flows only in combination with other tangible and intangible assets thus it is assumed that the contributory assets are rented or leased from a third party.

► Accordingly, contributory asset charges (“CACs”) are recognised within the cash flow determination to reflect the economic returns on & of all assets employed.

► This approach is reliable as long as all the intangible assets not subject to the valuation of the specific intangible asset, but necessary to its exploitation, have been properly identified.

**Issue to consider**

► Estimation of revenue and operating income generated by the intangible asset.

► Determination of the expected remaining useful life of the specific intangible asset.

► Accounting goodwill may not be identified.
As the MEEM allocates the entire residual income to the intangible asset in question (after deduction of appropriate CACs) it is often used to value core intangible assets. It is therefore fundamental to understand the intangible asset hierarchy within the business.
Incremental cash flow method

Definition

► The incremental cash flow method attempt to quantify the incremental benefit (and hence value) obtained from use of an intangible asset.

► The incremental cash flow is typically determined by reference to the selling price and profitability of similar 3rd party products or services that do not incorporate the IP in question i.e. they are “generic”.

► An example would be a branded product vs. an unbranded product of equivalent utility.

Issue to consider

► Same issues as the MEEM, plus:

► Estimation of cash flows derived without access to the IP is often difficult due to a lack of truly generic similar products or services.
Cost based approaches

- The cost approach relies upon the principle of substitution and recognises that a prudent investor will pay no more for an asset than the cost to replace it new with an identical or similar unit of equal utility.

  i. Replacement Cost New

  is defined as the current cost of producing or constructing a similar new item having the nearest equivalent utility as the asset being valued.

  ii. Cost of Reproduction New

  is the current cost of duplicating an identical item new. Under this approach, adjustments for the loss in value due to physical depreciation and functional and economic obsolescence must be taken into account.

Issues

- Cost to reproduce or replace an asset does not reflect the entire potential of the subject intangible asset to create value (for the business).

- Often difficult to identify costs directly related to the intangible asset subject to valuation, especially if the intangible asset was created a long time ago.
### Commonly applied valuation approaches

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Tax Amortisation Benefit: What is it?

► An adjustment to the values derived by the intangible asset valuation is made to reflect the hypothetical tax benefits associated with amortising the asset for income tax purposes.

► TAB is intended to quantify the benefit obtained from the tax savings associated with amortisation of capitalised intangible assets.

► The TAB associated with intangible assets is recognised when the purpose of the valuation is to estimate Fair Value under IFRS 3R.

► This also includes transactions where the specific purchaser will not be allowed to gross up and amortise the value of purchased intangible assets for income tax purposes.

The TAB is a valuation concept, not a tax or accounting concept. Whenever an intangible asset can be acquired by a bidder eligible for tax amortisation, the TAB value becomes an element for consideration in Fair Value.
What constitutes goodwill?

Cash flow

- Existing operations
- Intangible assets
- Goodwill

New products and customers

Time

Synergies

Valuation of intangibles: IFRS 3R, IAS 36, IAS 38
Impairment testing under IAS36

**Definition of recoverable amount**

(Paragraph 18, IAS 36)

The *higher* of an asset’s or a CGU’s:

- Fair value less costs to sell.
- Its value in use.

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**Valuation**

Fair value less costs to sell

The amount obtainable from the sale of an asset or CGU in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal.

**Accounting calculation**

Value in use

The present value of the future cash flows expected to be derived from an asset or cash-generating unit.

(Paragraph 6, IAS 36)
Recoverable amount under IAS36

FV less costs to sell

1. Market Approach
   - Both approaches reflect market participants’ view
   - Market assumptions (growth, synergies, etc.)

Value in Use

2. Income Approach
   - Five year business plan agreed by Board
   - Includes committed restructuring
   - Includes buyer-specific synergies
   - Reflect the market risk of the asset adjusted for the country, size, etc.
Per the standard, the discount rate used should be a pre-tax one. However, no observed market is available, hence a post-tax analysis is performed.

The discount rate used to determine the VIU should reflect the risks specific to the asset for which the future cash flow estimates have not been adjusted.

Consideration should be given to risk such as country risk, currency risk and price risk.

**Beta: Company specific or peer group?**

**Market risk premium: Current terms of capital market in which cash flows are created**

**Cost of debt:**

1. Current terms of capital market;
2. Currency of the business plan; and
3. Risk structure of peer group.

Specific risk adjustments (size, market, achievability of forecasts etc.)
Pre-tax vs. post-tax discount rate

The standard explains the rationale to use pre-tax cash flows and pre-tax discount rates. However this is not practical from a valuations perspective and in practice we use post tax discount rates to discount post tax cash flows, and then back solve for a pre-tax discount rate for disclosure purposes. This is not the same as grossing up after tax WACCs.

The ‘pre-tax’ discount rate typically cannot be directly observed or measured. It is calculated by iteration – by first running DCF calculation using post-tax cash flows and a post-tax discount rate, and then determining what the pre-tax discount rate would need to be to cause VIU determined using pre-tax cash flows to equal the VIU determined by the post-tax DCF calculation.
Questions?
Thank you

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