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Breakout 11

Intangible Asset Valuation

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Definitions – Intangible Asset and Intellectual Property

- IVSC GN 4 *Valuation of Intangible Assets* paragraph 3 defines an intangible asset as “A non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and economic benefits to its owner or the holder of an interest.
- International Accounting Standard 38, *Intangible Assets*, paragraph 8 defines an intangible asset as “identifiable non-monetary asset without physical substance.”
- ASC 350, *Intangibles-Goodwill and Other* defines intangible assets as “Assets (not including financial assets) that lack physical substance. (The term intangible assets is used in this Statement to refer to intangible assets other than goodwill.)”
- Intellectual Property (IP) – Creations of the mind – creative works or ideas embodied in a form that can be shared or can enable others to recreate, emulate, or manufacture them. There are four ways to protect intellectual property - patent, trademark, copyright, or trade secret.

Source: U.S. Patent and Trademark Office (USPTO) Glossary

International Valuation Standards Council (IVSC) – Issuance of Guidance Note 4, Valuation of Intangible Assets

- In February 2010, the International Valuation Standards Board of IVSC issued GN 4, *Valuation of Intangible Assets*.
- GNs are intended to guide experienced valuers on the application of the fundamental principles of the International Valuation Standards (IVS)
- Key section of GN 4 include:
  - Definitions
  - Types of Intangible Assets
  - Valuation approaches and methods
  - Valuation inputs
  - Reporting the Valuation
- GN 4 provides principles based guidance. Other materials cited in this presentation are based on other resources which provide more detailed insights into specific elements of intangibles valuation.

Definitions – Fair Value in a Financial Reporting Context

- **Fair Value Under IFRS,** *Fair Value Measurement , International Financial Reporting Standard "X", Staff Draft (paragraph IN6):*
  - This IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). The definition of fair value retains the exchange price notion in the definition of fair value used previously (ie the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction).
- **Fair Value Under US GAAP,** *Fair Value Measurements and Disclosures , Accounting Standards Codification 820:*
  - "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." (ASC 820-10-20).

Definitions – Fair Value in a Financial Reporting Context (cont'd.)

- A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. (ASC 820-10-35-19)
- "The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business)." (ASC 820-10-35-21)
- It is essential to view fair value from the point of view of market participants rather than a specific entity. Market participants are unrelated parties, knowledgeable of the asset or liability given due diligence, willing and able to transact for the asset/liability, and may be hypothetical. (ASC 820-10-20)

Definitions – Fair Value in a Financial Reporting Context - Market Participants

- Market participants are buyers and sellers in the principal or most advantageous market for the asset or liability.
- Market participants are:
  - Unrelated (i.e., independent) to the reporting entity
  - Knowledgeable about factors relevant to the asset or liability and the transaction
  - Financial and legal ability to transact
  - Willing to transact without compulsion
- Market participants may be either strategic or financial buyers.

Section 2:

Identification of Intangible Assets

Identification of Intangible Assets – Key Groupings

- Paragraph 3.2 of GN 4 indicates that intangibles may be contractual or non-contractual.
- GN 4 lists four principal classes of intangibles.
  - Marketing-related
  - Customer or supplier-related
  - Technology-related
  - Artistic-related
- IFRS and US GAAP provide more detailed information on types of intangibles.
- ASC 805, *Business Combinations*, includes the four groups above plus a fifth grouping – contract-based intangibles.

Identification of Intangible Assets – Marketing Related Intangible Assets

- Marketing-related intangible assets are primarily used in the marketing or promotion of products or services. The non-exhaustive listing includes:

  a. Trademarks, trade names, service marks, collective marks, certification marks

  b. Trade dress (unique color, shape, or package design)

  c. Newspaper mastheads

  d. Internet domain names

  e. Non-competition agreements

  Source: IVSC, GN 4 paragraph 3.3 and ASC 805-20-55-14 (non-exhaustive list).

Identification of Intangible Assets – Artistic-Related Intangible Assets

- Artistic-related intangible assets are those intangible assets of an artistic nature reflecting the creativity of the creator. These can include such items as:
  - a. Plays, operas, ballets
  - b. Books, magazines, newspapers, other literary works
  - c. Musical works such as compositions, song lyrics, advertising jingles
  - d. Pictures, photographs
  - e. Video and audiovisual material, including motion pictures, music videos, television programs

    Source: ASC 805-20-55-29 (non-exhaustive list).
- IVSC GN 4, paragraph 3.6. provides a similar but abbreviated listing of artistic-related intangibles.

Identification of Intangible Assets – Contract-Based Intangible Assets

- Contract-based intangible assets are established by contracts and include:
  a. Licensing, royalty, standstill agreements
  b. Advertising, construction, management, service or supply contracts
  c. Lease agreements
  d. Construction permits
  e. Franchise agreements
  f. Operating and broadcast rights
  g. Servicing contracts such as mortgage servicing contracts
  h. Employment contracts
  i. Use rights such as drilling, water, air, timber cutting, and route authorities

  Source: ASC 805-20-55-31 (non-exhaustive list).

Identification of Intangible Assets – Technology-Based Intangible Assets

- Technology-based intangible assets protect or support technology and include:
  - a. Patented technology
  - b. Computer software and mask works
  - c. Unpatented technology
  - d. Databases, including title plants
  - e. Trade secrets, such as secret formulas, processes, recipes

    Source: ASC 805-20-55-38 (non-exhaustive list).
- IVSC GN 4, paragraph 3.5. provides a similar listing of technology related intangibles.

Identification of Intangible Assets – Customer-Related Intangible Assets

- Customer or supplier-related intangible assets arise from relationships with or knowledge of customers or suppliers. Examples include, but are not limited to:
  - advertising, construction, management, service or supply agreements;
  - licensing and royalty agreements;
  - servicing contracts;
  - order books;
  - employment contracts;
  - use rights, such as drilling, water, air, timber cutting and airport landing slots;
  - franchise agreements;
  - customer relationships; or
  - customer lists.
  - <u>Source:</u> IVSC GN4, paragraph 3.4
- ASC 805-20-55-20 provides a similar listing.

Identification of Intangible Assets – Types of Customer-Related Intangible Assets

- **Order or production backlog:**
  - Arises from contracts or specific sales orders
  - Time, volume, price and quality **are** fixed
  - Contractual-legal basis would lead to recognition and valuation
- **Customer contracts and related customer relationships:**
  - Time volume, price and quality **are** stipulated
  - Contractual-legal basis would lead to recognition and valuation
- **Non-contractual customer relationships:**
  - Absence of legal rights to protect or control the relationship
  - Customer relationships where there is meaningful contact generally lead to recognition and valuation (exception – walk-in retail customers)

Section 3:

Summary Information on Cost and Market Approaches

Overview of Cost Approach – Definition

- *Definition of Cost Approach per IFRS X, Fair Value Measurement, paragraph 62 (Staff Draft):*
  - "The cost approach reflects the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant (seller), the price that would be received for the asset is based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant would not pay more for an asset than the amount for which it could replace the service capacity of that asset. Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives). The current replacement cost method is often used to measure the fair value of tangible assets used in combination with other assets or with other assets and liabilities."

Overview of Cost Approach – Considerations for Use

- Asset not directly associated with income generation of the business.
  - Readily replaceable workforce compared to complex FDA approval.
  - Internally-used software.
- When the cost of reconstructing or replacing an asset with a sufficiently comparable asset can be reasonably determined.
- Asset not readily valued using market or income approach.
- Economic obsolescence should be considered, but is difficult to quantify:
  - Does not consider **amount** of future economic benefits
  - Does not consider **timing and duration** of future economic benefits
  - Does not consider **risk**
- Subjectivity in developing cost estimates.
- Divergence in practice in treatment of tax attributes – (1) Use of pretax costs or (2) tax-affect pretax costs and apply amortization benefit factor.

Overview of Cost Approach – Comments on Criteria for Selection of Assets to Appraise

- The Cost Approach may be best suited for assets which are not a direct source of economic earnings for the business enterprise.
- Attributes of assets valued using the Cost Approach may also include:
  - Not an enabling asset which “drives” the business;
  - More easily replaced; and
  - Often less significant value relative to other intangible assets.
- The Cost Approach is often best suited for the appraisal of the following intangible assets:
  - Assembled workforce
  - Internally developed and used software
  - Engineering drawings
  - Packaging designs

Overview of Market Approach – Definition

- *Definition of Market Approach per IFRS X, Fair Value Measurement, paragraph 61 (Staff Draft):*
  - "The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets or liabilities (including a business). For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgement, considering qualitative and qualitative factors specific to the measurement. Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value various types of financial instruments such as debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities."

Overview of Market Approach – Considerations for Use

- To conduct a Market Approach, the appraiser needs to identify **arm's-length transactions** of guideline assets, disclosure of pricing information, and reasonable knowledge of the relevant facts.
- Publicly available market data are often not available for intangible assets.
  - Intangible assets are very unique.
  - When intangibles are sold, they are typically sold with other components of a business enterprise.
  - If sold individually, transactions are not often subject to public disclosure.
- Aside from the use of **market royalty rates**, the Market Approach is rarely used for valuing intangibles.
- Examples where Market Approach for an intangible asset are relatively limited. A few include:
  - Domain Names
  - Operating Rights - FCC Licenses and telecom operating spectrums

Section 4:

Overview of the Income Approach

Introduction - Appraisal Foundation Working Groups Contribute to Best Practices for Income Approach

- The Appraisal Foundation is working to enhance valuation practice for intangibles through the issuance of "Best Practices" documents.
  - *The Identification of Contributory Assets and the Calculation of Economic Rents* issued May 31, 2010. This document provides an extended discussion of key elements of Multi-Period Excess Earnings Method. Materials include:
    - Body
    - Comprehensive example
    - Glossary
    - Toolkit with charts and forms will be included in subsequent release
  - *Best Practices on the Valuation of Customer Relationships* draft document in process
  - *Best Practices for Measurement and Application of a Control Premium in Determining the Fair Value of Business or Reporting Unit for Financial Reporting Purposes* draft document in process

Overview of Income Approach – Definition

- *Definition of Income Approach per IFRS X, Fair Value Measurement, paragraph 62 (Staff Draft):*
  - The income approach uses valuation techniques to convert future amounts (eg cash flows or income and expenses) to a single present (discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts. Those valuation techniques include the following:
  - (a) present value techniques (see paragraphs B4–B22)
  - (b) option pricing models, such as the Black-Scholes-Merton formula (a closed form model) and a binomial model (a lattice model), which incorporate present value techniques and reflect both the time value and the intrinsic value of an option
  - (c) the multi-period excess earnings method, which is used to measure the fair value of some intangible assets.

Summary Bibliography

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