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Valuing intangible assets

What are they really worth?

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The value derived from intangible assets has increased significantly in today's knowledge based economy. The book value of many publicly quoted companies is significantly less than the market value. Stock market value is derived, to a large extent, from assets that do not appear on the balance sheet. This highlights the increasing significance of intangible assets and their importance in acquisitions.

Developments in International Financial Reporting Standards (IFRS) have considerably broadened the definition of intangible assets. With the mandatory application of IFRS to listed entities, the option for other entities to move to IFRS and the likelihood that Irish standards will adopt a similar approach as part of the overall convergence programme, identification and valuation of intangibles will become a challenge for all companies engaging in acquisition activity.

The principal driver behind purchase price allocation (PPA) is to bring greater transparency to the acquisition process, to identify and value the assets being acquired and to arrive at the net residual amount which will be attributed to goodwill. Intangible assets will generally be amortised over a period of up to twenty years. In some cases, they may be considered to have indefinite economic lives and therefore, not subject to amortisation. On the other hand, IFRS does not permit the amortisation of goodwill but instead requires an annual impairment review which, in itself, may lead to volatility in reported earnings. Accordingly, companies will be keen to ensure that intangible assets are fully identified and accounted for separately from goodwill. Many commentators are of the view that, under current Irish standards, the residual amount of goodwill is very much a mixed bucket of various intangibles and does not always present meaningful information regarding asset worth for investors.

The new standards have implications for all transactions both from a commercial and an accounting perspective. Deloitte has recently performed a number of purchase price allocations. Based on our experience, we believe the following points should be considered when identifying and valuing intangible assets.

Identification of intangible assets

IFRS provides illustrative examples of items acquired in a business combination that meet the definition of an intangible asset and are therefore recognised separately from goodwill, provided that their fair values can be measured reliably. To meet the definition of an intangible, a non-monetary asset without physical substance must be identifiable, i.e. must arise from contractual or other legal rights or be separable.

The examples are not exhaustive, but provide a useful framework for the determination of intangible assets. The examples fall into five categories (as shown below).

Intangible Asset categories	Examples include:
1. Marketing-related intangible assets	Trademarks, trade names, service marks, newspaper mastheads, internet domain names, non-competition agreements.
2. Customer-related intangible assets	Customer lists, order or production backlogs, customer contracts and customer relationships including non-contractual relationships.
3. Artistic-related intangible assets	Plays, operas, ballets, books, magazines, newspapers, pictures, photographs.
4. Contract-based intangible assets	Licensing and royalty agreements, advertising, construction, service or supply agreements, lease agreements, franchise agreements, employment contracts.
5. Technology-based intangible assets	Patented technology, computer software, unpatented technology (know-how), databases, trade secrets such as secret formulas, processes and recipes.

The identification process is critical. Based on our experience, the recognition and measurement of intangible assets must be assessed on a case by case basis.

Identification and valuation of intangibles made simple

Valuation techniques

Following the identification of intangible assets, the next step is to determine the fair value of the intangible assets. IFRS provides limited guidance on determining fair value. However, the main valuation methodologies used are:

Market methods - value intangible assets by reference to transactions that occurred recently in similar markets, or benchmarks of comparable assets.

This methodology can provide the best evidence of fair values because it relies on evidence from actual market transactions. However, outright sales and purchases of intangible assets are infrequent and details of those that take place are rarely fully available. It can be difficult to ensure that the asset under consideration and that subject to the market transaction are sufficiently comparable. Therefore, this methodology can be difficult to apply in practice.

Income methods - value intangible assets on the basis of the future economic benefits derived from ownership of the asset. The income approach seeks to identify and quantify, in present day terms, the future earnings attributable to the asset. We have used this method to value brands, customer relationships, patented technology and unpatented technology (know-how).

The income based valuation of an intangible asset has two distinct components:

- identification, separation and quantification of the cash flows (or earnings) attributable to the intangible asset; and
- capitalisation of those cash flows (or earnings).

The main income methods are Relief from Royalty and Excess Earnings. Relief from Royalty is a methodology based on estimating the price a business would pay for the use of an intangible asset if it did not own the asset, or the cost savings of not having to pay a royalty.

The basis of the Excess Earnings methodology is that the value of an intangible asset is the present value of the earnings it generates, net of a reasonable return on other assets also contributing to that stream of earnings.

Cost methods - value intangible assets by assessing the development or replacement cost of the asset.

The cost approach is used for valuing internally developed assets e.g. software. Cost based approaches should be viewed with caution, as the cost of recreating or replacing an asset of this nature is not necessarily an accurate indication of the future value of that asset. However, cost methods can be a useful benchmark for a valuation.

The appropriateness of each of these valuation methodologies varies according to the type of asset, available data and the specific circumstances of different industries.

Valuation issues

In our experience, common issues include:

- Identification of intangible assets. There may be varying opinions within management concerning the key intangible assets acquired. The identification of intangible assets leads to much debate.
- Choosing an appropriate valuation methodology. Although market methods are best where available, the lack of market evidence means that income methods are more often applied.
- The determination of appropriate assumptions requires experience and judgement due to the subjectivity involved.
- One of the key challenges of accounting for intangible assets is selecting appropriate economic lives for each item or category. Some assets such as strong brand names may have a relatively long or even indefinite life, others such as customer relationships or databases, may be amortised over a shorter period.
- The process of selecting an appropriate royalty rate range based on market evidence needs to be rigorous, as the value implications of a small change in the royalty rate can be significant.
- The determination of the cost of capital requires experience and judgement. The cost of capital should be consistent with the risks and rewards of the intangible asset being valued.
- Projections need to be carefully reviewed as this will impact on the value of the intangibles and will have a bearing on future impairment reviews.
- Avoiding double counting of intangible value as two or more intangible assets may contribute to the same stream of earnings e.g. a well known trade mark and the underlying technology.
- Impact on EPS. The reduced amortisation charge will initially have a positive impact on EPS. However, the annual impairment reviews required by IFRS may lead to volatility of earnings. If the revenue from particular brands or customers is less than the initial projections, a significant write-down is necessary.
- Long term implications of identifying certain intangibles. In the event that a brand name is changed post acquisition, this could lead to a substantial write-down.
- Taxation implications - it is necessary to identify situations where intangible assets are being used by other members of a group of companies and that a market value charge is made for them.

Many companies involved in acquisitions will require the assistance of external advisors in valuing and accounting for the intangible assets purchased as part of a business.

Intangible Assets Valuation Approach

Background Research

- Overview: industry, market and countries of operation.
- Company: operations, customers, suppliers, financing.
- Client information: forecasts, internal documentation, legal documentation.
- Comparable transactions.

Intangible Asset Identification

- Reasons for the acquisition.
- Available documents (board presentations, information memorandum, due diligence reports, share purchase agreements).
- Purchase price consideration model.
- Are recognition and identification criteria met?
- Do Accounting Standards provide specific guidance on this type of intangible asset?

Select Valuation Methodology

- IAS 36/IAS 38/IFRS 3 guidelines.
- Information available.
- Commercial practice.
- Valuation experience.
- Alternative methodology available?

Market Methods

Income Methods

Cost Methods

Value the Intangible Assets

- Integration of financial and market data.
- Estimate useful life: finite/infinite.
- Application of selected valuation methodology.
- Additional research: data sources.
- Assumptions including royalty rates / discount rates.
- Weighted average cost of capital calculation.
- Sensitivity analysis on projections/analyses.
- Reporting/presentation.

Summary

The valuation of intangible assets is important both from an accounting and commercial perspective. As companies now become more knowledge based, intangible assets will comprise an increasing percentage of the value of businesses acquired.

There are implications for deal makers - IFRS will force deal makers to focus on what they are really buying. Any premium paid over the net tangible assets will be subject to much debate. IFRS ensures that the results of acquisitions can be evaluated by investors long after the deal is closed. Given the implications of these new standards, companies should consider identifying and valuing intangible assets as part of the due diligence process before completing a deal and should take this into account when agreeing on the final purchase consideration. Deal makers need to consider whether the intangibles they are bidding for add up to the final consideration.

Valuing intangible assets is not merely a one off exercise, the requirement for annual impairment reviews will require the ongoing evaluation of intangible assets. At each reporting date a company is required to assess whether any asset is impaired or whether intangible assets have lost value.

IFRS has significant ongoing implications for acquisitions.

How can we help?

At Deloitte we have a dedicated multi-disciplinary team which offers valuation and accounting advice on intangible assets to assist with all aspects of international reporting requirements.

We have:
- Extensive knowledge of valuation theory and practical experience in applying the new standards;
- Experience in valuing businesses and intangible assets for purchase price allocations;
- Accounting and taxation expertise; and
- Industry specialists across all major sectors.

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