

Guidance on valuing Intangible Assets

Relevant requirements of IFRS 3 and IAS 38

An amended version of IFRS 3 was issued in January 2008. The amendments were effective for accounting periods beginning on or after 1 July 2009, but early application was permitted. This guidance reflects the amended version of IFRS 3 together with consequential amendments made to IAS 38.

IFRS 3, paragraph 13, and IAS 38, paragraph 34, requires that intangible assets arising from a business combination are recognized at their fair value at the acquisition date irrespective of whether the assets had been recognized by the acquiree before the business combination. The key issue is whether the definition of a separately identifiable intangible asset as set out in IAS 38 is satisfied. In practice, insignificant separately identifiable assets may not need to be separately valued.

IAS 38 suggests that if an intangible asset arises from a business combination, then sufficient information will exist for the fair value of the intangible to be reliably measurable. When there is a range of possible outcomes in the estimates used to measure fair value, uncertainty enters into the measurement of fair value. However, just because an intangible asset may be difficult to value that does not mean it should not be recognised at fair value.

Measurement of goodwill

Under IFRS 3, the initial measurement of goodwill arising from a business combination is the difference between A and B as shown below.

"A" comprises:

- The consideration transferred, the fair value of any equity issued as consideration and any liabilities or obligations assumed;
 - The amount of any non-controlling interest in the acquiree, and
 - The acquisition-date fair value of the acquirer's previously-held interest in the acquiree, if any.

"B" comprises

- The net sum of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed.

The reporting entity can choose to measure the amount of any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.

- If the amount of the non-controlling interest is measured at fair value, it will include any goodwill attributable to the non-controlling interest.
- If the amount of the non-controlling interest is measured at the proportionate share of the acquiree's identifiable net assets, it will exclude any goodwill attributable to the non-controlling interest.

Thus, there is a choice as to whether goodwill is recognised in the balance sheet at:

- The full amount of goodwill relating to both the stake the acquirer has purchased and the stake, if any, that the acquirer has not purchased and remains as a non-controlling interest; or
- The acquirer's share of the goodwill, i.e. that relating only to the stake in the acquiree that the acquirer has purchased.

Aggregation of intangible assets for valuation purposes

IAS 38, paragraphs 36 and 37, addresses the circumstances in which it is appropriate to combine certain tangible and intangible assets for the purposes of determining their fair value following a business combination.

IAS 38, paragraph 36, notes that it is appropriate to combine an intangible asset with another intangible asset or with a tangible asset, if the underlying intangible asset is not separable and its fair value is not reliably measurable. The paragraph cites:

- As an example of intangible assets that may not be separable individually, a magazine's publishing title and its subscriber database; and
- As an example of a tangible and intangible asset that may not be separable individually, a trademark for a natural spring water and the spring itself.

IAS 38, paragraph 37, considers the term 'brand'. It notes that this term is a general marketing term that is often used to refer to a group of complementary assets such as a trademark and its related trade name, formulas, recipes and technological expertise.

The paragraph notes the following.

- "The acquirer recognizes as a single asset a group of complementary intangible assets comprising a brand if the individual fair values of the complementary assets are not reliably measurable". This is a required aggregation of the underlying assets.
- "If the individual fair values of the complementary assets are reliably measurable, an acquirer may recognize them as a single asset provided the individual assets have similar useful lives." This is a permitted aggregation of the underlying intangible assets.

The guidance in paragraphs 36 and 37 of IAS 38 is used extensively in practice. The consequence of applying these paragraphs is that the number of intangible assets that must be valued following a business combination is reduced. In practice, these paragraphs are generally applied in the case of different, rather than similar or identical, intangible assets. For instance, the individual component intangible assets comprising a brand are different, as are a magazine title and its subscriber database.

The effect of aggregating the intangible assets is that a new intangible asset that is different from its component parts is created.

IAS 38 does not, specifically, address whether similar or identical intangible assets should be aggregated for the purpose of initial measurement. In practice, certain types of similar intangible assets that together form a portfolio of similar intangible assets are frequently aggregated for ease of valuation.

Examples of intangible asset that might be acquired and that form portfolios are customer contracts and customer relationships, which are individually likely to be similar or occasionally identical to one another. The

groupings are likely to comprise all intangible assets that share particular attributes - e.g. all rental contracts with a three-year term for the same piece of software, or all rental contracts with a five-year term for the same piece of software.

The aggregation of portfolios of intangible assets such as these allows cancellations, renewals and default levels on contracts to be assessed on a portfolio basis rather than at an individual asset level. In this way, historical patterns for a portfolio can be used to predict future expectations. This is likely to lead to more robust assumptions than trying to predict patterns without using portfolio evidence.

The valuation should take account of the extent to which the individual intangible assets share the same characteristics in deciding how this aggregation should be effected. Any such aggregation, the nature of the underlying assets, and the characteristics of the underlying assets rendering aggregation appropriate for valuation purposes should be documented in the Valuation Report.

Cross checking the valuation

Prior to performing any valuation of the intangible assets in a business combination, it is common practice to value the whole of the acquired business. This will necessitate forecasting cash flows for the business and discounting them at a suitable cost of capital to reflect the risks specific to the acquired business. If the cash flows are discounted at the weighted average cost of capital of the acquired business, the net present value arising from the DCF exercise represents the 'enterprise value' of the business.

The value of the equity in the acquired business is determined by deducting the net debt from the enterprise value. This should be compared with the price paid for the equity purchased.

If the two figures are relatively close, the projections and the discount rate used in the valuation of the business are effectively supported by the price paid for the acquisition. In this case the projections and the discount rate can be used as starting points in the determination of the corresponding valuation inputs in the valuation methods applied to the intangible assets. In the case of the discount rate, adjustments will be required, to make the discount rate suitable for intangible assets rather than the business as a whole.

If the DCF-derived value for equity and the price paid for the combination are not relatively close, this would suggest that one or more of the following has occurred:

- The projections used to value the business were not realistic;
- The discount rate used to value the business was not realistic;
- The price paid for the business was low and a bargain purchase has been achieved;

or

- The price paid for the business was high and the purchase may have been made at an overpayment. Unless the price reflected synergies arising from the combination.

In this case, judgment has to be used to determine whether the projections and/or discount rate should be adjusted before using them as starting points for the determination of the corresponding valuation inputs in the valuation of the intangible assets.

The internal rate of return implicit in the acquisition of the business or the weighted average return on assets could also be used to provide support for both the projections and the discount rate used in the valuation

Source :Guidance Note of the International Valuation Standards Council

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