

# Key advisory issues

## Intangible assets: recognising and exploiting their value

As economies have evolved over time, so have businesses evolved from being physically intensive to relying more on intangible assets. The purpose of this chapter is to provide an overview of the valuation of intangible assets and to provide evidence of intangible asset value.

The chapter first sets out descriptions and examples of intangible assets. It then discusses the common methodologies used to value intangible assets and how these relate to valuations for financial reporting purposes. Finally, it gives examples of how companies can recognise intangible asset value in the marketplace and the resulting implications in respect of the heightened awareness of intangible assets.

### Overview

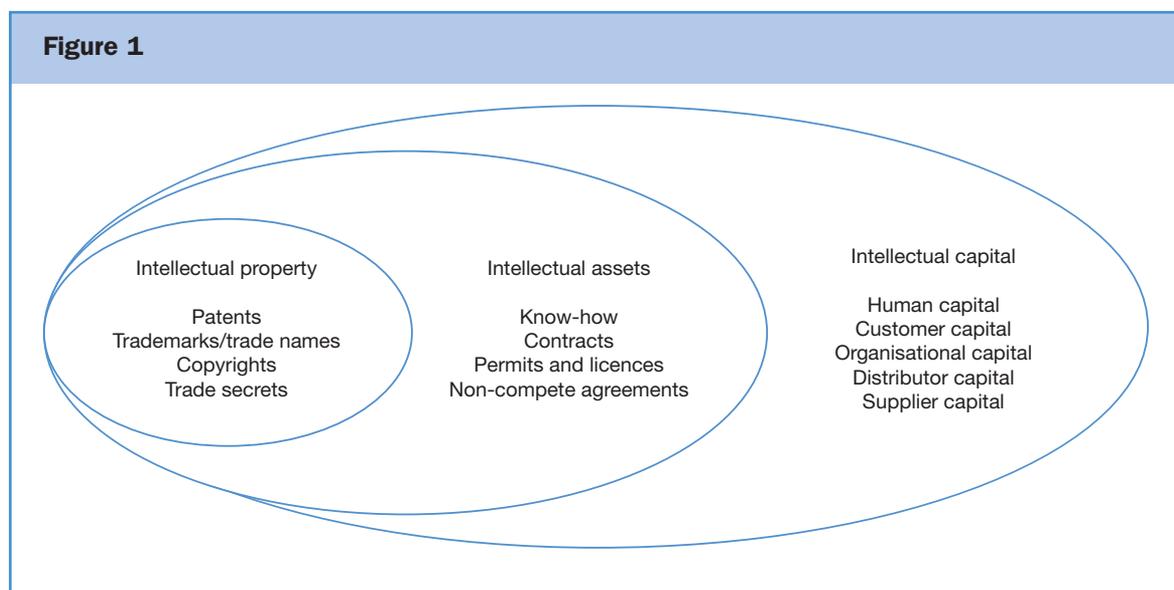
Intangible assets can be broken down into three areas as shown in Figure 1: intellectual capital, intellectual assets and intellectual property.

Intellectual capital is the cumulative knowledge of a business which allows for knowledge transfer and leverage. It creates a competitive advantage and represents a combination of human capital, intellectual assets and intellectual property.

Intellectual assets represent the codified tangible or physical descriptions of specific knowledge to which a company can assert ownership rights. They include, but are not limited to, know-how, contracts, permits and licences and non-compete agreements.

‘Intellectual property’ is a term used for various legal entitlements which attach to certain names, written and recorded media and inventions. These assets may:

- generate premium pricing on products or services;
- create a competitive cost advantage;
- enable companies to overcome barriers to entry;
- establish technological superiority; and/or
- enhance market share.



For these reasons, intellectual property is becoming a more important factor in mergers and acquisitions.

According to Statement of Financial Accounting Standards (SFAS) 141, intangible assets can be categorised into five broad areas:

- marketing-related intangible assets:
  - trademarks and trade names;
  - service marks, collective marks and certification marks;
  - trade dress;
  - newspaper mastheads;
  - internet domain names; and
  - non-compete agreements;
- customer-related intangible assets:
  - customer lists;
  - order or production backlog;
  - customer contracts and related customer relationships; and
  - non-contractual customer relationships;
- arts-related intangible assets:
  - plays, operas and ballets;
  - books, magazines and newspapers;
  - musical works;
  - pictures and photographs; and
  - video and audiovisual material;
- contract-based intangible assets:
  - licensing, royalty and standstill agreements;
  - advertising, construction, management and supply contracts;
  - lease agreements;
  - construction permits;
  - franchise agreements;
  - operating and broadcast rights;
  - use rights;
  - service contracts; and
  - employment contracts; and
- technology-based intangible assets:
  - patented technology;
  - computer software and mask works;
  - unpatented technology;
  - databases; and
  - trade secrets.

The ability of companies to exploit and protect these assets is one of the main factors influencing and driving the value of intangible assets.

### Valuation methodologies

Valuation professionals generally consider intangible asset valuations to be more of an art than a science. 'Fair value' can be defined as "the amount for which an asset

could be exchanged, or a liability settled, in a current transaction between knowledgeable, willing parties in an arm's-length transaction", as set out in Appendix A of International Financial Reporting Standard (IFRS) 3. In order to value intangible assets for financial reporting and tax purposes, one or more of the following generally accepted valuation approaches is utilised.

#### Market approach

In the market approach, recent sales and market listings of comparable assets are gathered and analysed. If necessary, adjustments are then applied to these observations to recognise differences in characteristics between the subject assets and the comparable assets in order to indicate a fair value for the asset.

#### Income approach

The income approach is based on the premise that the value of a security or asset is the present value of the future earning capacity that is available for distribution to the subject investors in the security or asset. Within the income approach, there are several methodologies, including:

- the discounted cash-flow method;
- the excess earnings method; and
- the relief from royalty method.

#### *Discounted cash-flow method*

The most commonly used income approach to the valuation of securities or individual assets is a discounted cash-flow analysis, which involves forecasting the appropriate cash-flow stream over an appropriate period and then discounting it back to a present value at an appropriate discount rate that considers time, the value of money, inflation and the risk inherent in ownership of the asset or security interest being valued.

#### *Excess earnings method*

This method is predicated on the basis that the value of an intangible asset is the present value of the earnings it generates, net of a reasonable return on other assets which also contribute to that stream of earnings.

#### *Relief from royalty method*

The principle of the relief from royalty approach asserts that the value of an intangible asset is what the owner would pay to license the asset if it did not own it. In other words, the value equates to the cost avoided by not having to pay a royalty.

### Cost approach

Under the cost-based methodology, the value of an intangible asset is estimated by reference to the costs that would be incurred in order to recreate the asset. It assesses the theoretical cost of the labour and materials necessary to construct or acquire a new asset of similar utility to the subject asset. The cost approach is not considered to be an appropriate approach for valuing income-generating intangible assets as generally it does not capture any future profits associated with the intangible asset.

### Application of valuation approaches

When valuing intangible assets, the market approach is the most preferred approach as it provides market evidence as to what third parties have paid for comparable assets. However, in practice, this approach is difficult to apply as typically there are very few comparable public transactions involving readily separable intangible assets.

One example where market information is available relates to patents, trademarks and trade names. While it is possible to gather information related to the royalties paid for certain patents, trademarks or trade names, in reality this information can be difficult to apply as the transactions involving brand or patent royalties often also include the right to use other intangible assets. In addition, many transactions involving intangible assets are carried out for internal transfer pricing purposes and are not available to the public.

Therefore, in the majority of cases, comparable market data is not available, which results in valuation professionals relying on both the income and cost approaches to estimate the fair values of intangible assets.

### Valuations for financial reporting purposes

In March 2004 the International Accounting Standards Board adopted IFRS 3 – Business Combinations, which requires the valuation of all assets, including tangible and intangible assets and liabilities acquired in a transaction. IFRS 3 was adopted by all companies listed on the London Stock Exchange for periods commencing January 1 2005 and became mandatory for companies listed on the AIM for periods commencing January 1 2007. Given these requirements, the valuation of intangible assets has become much more important.

IFRS 3 followed the Financial Accounting Standards Board's issuance of SFAS 141 in June 2001, requiring all public companies in the United States to perform a purchase price allocation, which involves estimating the fair value of all assets and liabilities assumed in transactions carried out from January 1 2002.

The purchase price allocation process generally falls into four broad categories:

- identification of intangible assets;
- estimation of discount rate;
- valuation analysis; and
- reconciliation of results.

### Intangible asset identification

The identification phase of a purchase price allocation involves identifying intangible assets that meet either the separability or contractual criteria as set out in the accounting standards. The identification process typically involves having discussions with management and reviewing sales purchase agreements, due diligence documents, public filings and other internal documentation.

### Discount rate

Once the intangible assets have been identified, the next step is to estimate the overall discount rate for the target company. At this stage, a weighted average cost of capital (WACC) analysis is prepared based on estimates of required equity rates of return and after-tax costs of debt based upon a group of peer companies. In addition to the WACC, a business enterprise valuation is prepared in order to estimate the internal rate of return in the transaction. The cash flows in the internal rate of return analysis should consider whether expected synergies in the transaction would be considered unique or market participant synergies. These cash flows serve as the basis for the cash flows used to value the identifiable intangible assets.

### Valuation analysis

The next phase involves the valuation of the intangible assets using the generally accepted valuation approaches (ie, market, income and cost).

### Reconciliation of results

The final phase of the purchase price allocation process is to reconcile the fair value results. This process consists of preparing a weighted average return on assets analysis. As part of this analysis, the weighted returns for each net tangible and intangible asset are added up and compared to the WACC to check the reasonableness of the intangible asset discount rates. As part of this process, a valuation practitioner should consider the risk of each intangible asset in relation to the others and in relation to the overall return expected for the business and for goodwill. Typically, intangible asset required returns tend to equal or exceed the overall WACC, but require a lower return than goodwill.

**Table 1**

	As % of total purchase price <sup>(1)</sup>	
	Identifiable intangible assets	Total intellectual property
Min	0%	0%
Max	111%	86%
Average	31%	12%
Identifiable intangible assets/intellectual property sample size	27%	12%
	30%	30%

<sup>(1)</sup> 'Total purchase price' is defined as common equity, preferred equity, and interest-bearing debt

### Evidence of value

To give a snapshot of which intangible assets companies are recognising and valuing in transactions, approximately 30 of the largest transactions in 2006 in the United Kingdom and the United States were considered (where information related to identifiable intangible assets was readily available in public filings).

For each transaction, the fair values attributed to intellectual property, total identifiable intangible assets and goodwill were gathered. These intangible asset values were then compared to the overall invested capital in the transaction. For the purposes of this analysis, 'invested capital' was defined as the fair value of common equity, preferred equity and interest-bearing debt.

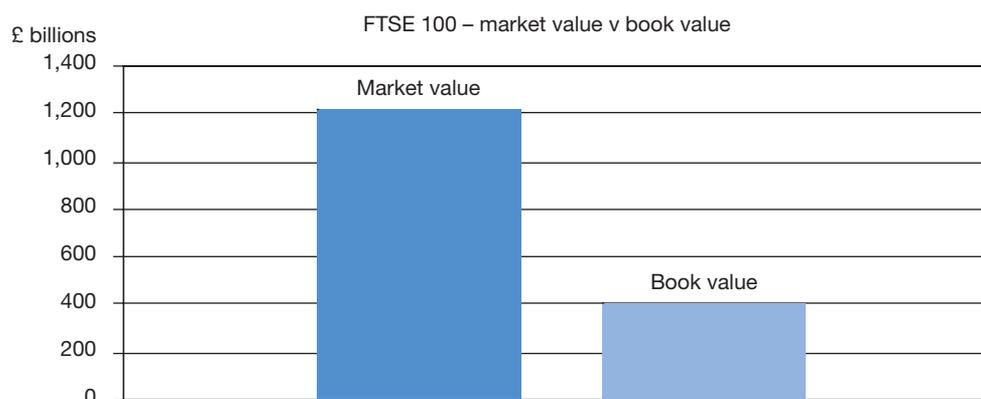
As shown in Table 1, companies recognised and valued identifiable intangible assets in 90 per cent (27 out of 30) of the transactions researched, with intellectual property being recognised and valued in almost half of those transactions (12 out of 30). Overall, the values associated with the total identifiable intangible assets on average represented almost one-third of the total purchase, suggesting that these assets are not insignificant.

The value that the markets attribute to intangible assets is also evidenced in the stock markets on a daily basis. As shown in Figure 2, the market capitalisation of the FTSE 100 as of August 31 2007 was approximately three times the book value of the equity, which indicates that a significant proportion of companies' market value is derived from and influenced by intangible assets (these figures exclude real estate companies and financial institutions).

Another example of intangible assets' value in the marketplace involves financial securitisation and collateralisation. Since 1995 the Development Bank of Japan has granted more than 250 loans to venture capital firms where the collateral for these loans includes patents, patent applications and copyrights of computer programs.

Other examples providing evidence that intangible assets have perceived value in the marketplace include:

- securitisation of music or image rights;
- IP applications;
- IP protections;

**Figure 2**

- litigation/disputes;
- corporate transactions;
- transfer pricing; and
- licensing.

### Implications

Proponents of SFAS 141 and IFRS 3 believe that the adoption of these standards will result in more transparency given the disclosure of the values associated with the acquired intangible assets. Opponents of the recent accounting standards believe that intangible assets cannot be effectively measured on a consistent basis and that only a limited number of

professionals have experience valuing intangible assets.

Regardless of whether the accounting standards create greater transparency, these standards have brought more attention to intangible asset values.

As intangible assets continue to grow and companies continue to hire executives specifically to manage intangible assets, the need to measure and value intangible assets accurately increases. More importantly, knowing and understanding the value of a company's intangible assets will become increasingly important as companies try to align these values with their strategic planning decisions and management of the business.

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