January 2009

INTERNATIONAL VALUATION STANDARDS COUNCIL

EXPOSURE DRAFT

Revised International Valuation Guidance Note No. 4
Valuation of Intangible Assets

Comments to be received by 30 April 2009

IVSC

EXPOSURE DRAFT OF PROPOSED REVISED INTERNATIONAL VALUATION GUIDANCE NOTE NO. 4 *VALUATION OF INTANGIBLE ASSETS*

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This Exposure Draft is published by the International Valuation Standards Board for comment only. The International Valuation Standards Board is the independent standard-setting body of the International Valuation Standards Council.

Comments on this Exposure Draft are invited by 30 April 2009. All replies may be put on public record unless confidentiality is requested by the respondent. Comments may be sent as email attachments to CommentLetters@ivsc.org, or by post to International Valuation Standards Board, 12 Great George Street, Parliament Square, LONDON SW1P 3AD, United Kingdom.

Note for respondents

In August 2007 the International Valuation Standards Committee published a discussion paper *"Determination of Fair Value of Intangible Assets for IFRS Reporting Purposes"*. This invited responses on both the scope of any future guidance and the accuracy of the technical content. Following analysis of the responses received, a Round Table meeting held in New York in May 2008 and further consultations with other respondents and interested parties, the outgoing Committee recommended that the project should move forward as follows:

- That the existing GN4 *Intangible Assets* should be revised and updated to reflect key aspects of the discussion paper and the responses.
- That a new GN 16 *Valuation of Intangible Assets for IFRS Reporting Purposes* should be developed.
- That the newly formed International Valuation Professional Board be asked to consider developing an educational paper examining the application of some of the principles discussed in the new Guidance Notes, with reference to examples.

The new International Valuation Standards Board has accepted this recommendation.

This paper is an Exposure Draft of the proposed revisions to the current GN4. The structure and many of the technical terms used in the existing GN have been revised, although the fundamental valuation approaches and reporting requirements are unchanged. The changes that have been made are designed to make it easier to translate the valuation requirements for intangible assets under IFRS into IVS. Although GN4 is of generic application and can be used for different valuation purposes, the Board considered that there was little merit in IVS maintaining different terms for similar concepts where these arose under IFRS, unless there was sound reason for this. This approach means that GN 4 can be applied to valuations under IFRS, subject only to the supplemental guidance in GN16, as well as to other types of valuation.

Questions for respondents

1 The existing GN4 in the International Valuation Standards (IVS) contains a lengthy list of definitions. During the review of this draft the Board formed a view that the majority of these definitions were unnecessary as they were of words or terms that were used in the text in accordance with their normal dictionary meaning or that were otherwise widely understood. It also has to be borne in mind that this GN is designed to be part of IVS, which already defines many valuation terms, such as different bases of value. This Exposure Draft only defines "Goodwill" and "Intangible Asset".

Do respondents consider that further definitions are necessary to explain terms that are used in this draft?

2 Section 3 is a discussion on the identification of different types of Intangible Asset. This uses the four category descriptions of "Marketing Related", Customer or Supplier Related", "Artistic Related" and "Technology Related", with a note that under each of these categories, assets may be either contractual or non-contractual. These categories are different from those in the existing GN4 but are similar to those used in the Illustrative Examples in previous versions of IFRS 3. Under IFRS 3 "Contract Based Intangible Assets" are identified as a separate Category. The Board is interested in the views of respondents on:

- Whether the categorisation of Intangible Assets is important because it helps valuers identify assets that have similar characteristics and for which similar valuation approaches may be adopted, or whether it is simply a convenient way of describing the different types of asset that exist?
- If categorisation is important, is it important that the categories in GN 4 follow the illustrative examples in IFRS 3?
- If is considered important to follow the categorisation in IFRSs, should "Contract Related" assets be separately categorised from the other types?

3 Various common valuation methods are described in this draft. These are been based on those in the discussion paper and the responses received. The Board would be interested to learn if respondents consider that the major valuation methods in use for the valuation of intangibles assets are all included? Conversely, are methods included that are seldom used in practice?

4 The aim of the Guidance Note is to identify the principal approaches and methods used in intangible asset valuation and define them, with the objective of reducing the diversity of terminology and making valuation reports more comprehensible to users. It is not to provide a comprehensive discussion of all the nuances of different valuation techniques nor instructions on how to value.

Some members of the expert group involved in the preparation of the Exposure Draft considered that the Guidance Note provides too much detail, especially in relation to the discussion on Valuation Inputs. They believe that this material risks being interpreted as either constraining a valuer's discretionary judgement or giving limited, and therefore potentially misleading, instruction. The Board would be interested in the views of respondents on the degree of detail in the Guidance Note, and particularly if this goes beyond that which is necessary for a professional user of an intangible asset valuation to understand the basic techniques and principles that an expert valuer should normally adopt.

5 Section 6, *Selection of Valuation Methods* advocates the use of multiple valuation methods when the necessary data is available without undue difficulty or cost, and gives guidance on how these methods may be ranked in different situations. Do respondents agree that it is preferable to use multiple methods, and if so, do they consider that the guidance provided is sufficiently comprehensive to prevent unnecessary cost and confusion being incurred in undertaking valuations of intangible assets?

Exposure Draft

Revised International Valuation Guidance Note No. 4

Valuation of Intangible Assets

Contents

1 *Introduction and Scope*

1.1 The International Valuation Standards Board (the "Board") issues Guidance Notes (GNs) to guide experienced valuers on the application of the fundamental principles of the International Valuation Standards (IVS) to a specific asset type or for a specific valuation purpose. A GN is also intended to provide information to those who commission or rely on valuations and their professional advisors on the generally recognised principles that a valuer should follow and of the principal techniques and methods that may be used. Because of the range of asset types and of purposes for which valuations are required, a GN cannot provide authoritative guidance for every valuation situation and departure from the principles described may be justified in certain situations. A GN does not provide instruction on how to value nor detailed discussion on the merits of different valuation techniques.

1.2 The objective of this GN is to provide guidance on internationally recognised principles under which valuations of intangible assets are performed and the principal approaches and methods that are used for valuing this type of asset. Many of these are similar to those that apply to the valuation of other types of asset; this guidance should therefore be read in conjunction with the International Valuation Standards, and in particular IVS 1 '*Market Value Basis of Valuation'*, IVS 2, '*Bases other than Market Value'*, and IVS 3, '*Valuation Reporting*'.

1.3 Valuations of intangible assets are required for many different purposes including:

- acquisitions, mergers and sales of businesses or parts of businesses
- purchases and sales of intangible assets
- reporting to tax authorities
- litigation; and
- financial reporting.

1.4 Additional guidance on the valuation of intangible assets specifically for the purpose of financial reporting under International Financial Reporting Standards, 'IFRSs', can be found in GN16, '*Valuation of Intangible Assets for IFRS Reporting Purposes'*.

2 *Definitions*

2.1 *Goodwill:* Any economic benefit arising from an asset or assets that is not capable of being individually identified and separately recognised.

2.2 *Intangible Asset:* A non monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and privileges to its owner that usually generate income.

3 *Types of Intangible Asset*

3.1 An intangible asset can be either identifiable or unidentifiable. An asset is identifiable if it either:

- is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Any unidentifiable intangible asset associated with a business is generally termed *goodwill.*

3.2 *Goodwill* is a future economic benefit attaching to a business. *Goodwill* cannot be secured legally by a business and is not separable from a business. Examples of *goodwill* include:

- the tendency for customers to return to a place of business;
- the extra income generated by a business over and above a fair return from the identifiable tangible, intangible or monetary assets; or
- the extra value of the entity as a whole over and above the aggregate value of its identifiable tangible, intangible or monetary assets.

In general terms, the value of *goodwill* is the residual amount remaining after the value of all identifiable tangible, intangible and monetary assets less liabilities and potential liabilities have been deducted from the total value of a business.

3.3 Identifiable intangible assets may be contractual or non -contractual. Set out below are the principal classes of intangible asset; within each class, assets may be either contractual or non contractual.

3.4. **Marketing-related** intangible assets are used primarily in the marketing or promotion of products or services. Examples include:

- trademarks, trade names, service marks, collective marks and certification marks;
- trade dress (unique colour, shape or package design)
- newspaper mastheads
- internet domain names
- non-compete agreements

3.5 **Customer or supplier-related** intangible assets arise from relationships with or knowledge of customers or suppliers. Examples include:

- advertising, construction, management, service or supply agreements
- licensing, royalty and standstill agreements
- servicing contracts
- order books
- employment contracts
- use rights, such as drilling, water, air, timber cutting and airport landing slots
- franchise agreements
- customer relationships
- customer lists

3.6 **Technology-related** intangible assets arise from contractual and rights to use technology (patented and unpatented), databases, formulae, designs, software, processes and recipes.

3.7 **Artistic-related** intangible assets arise from the right to benefits such as royalties from artistic works such as plays, books, films and music, and from non contractual copyright protection.

3.8 Specific intangible assets are defined and identified by characteristics such as their function, market position, global reach, market profile, capability and image. These characteristics differentiate intangible assets from one another. For instance:

- confectionery brands may be differentiated through differing taste, source of ingredients and quality; and

- computer software products will typically be differentiated by reference to their functional specifications.

3.9 The characteristics of an intangible asset include the ownership rights, privileges and conditions attributable to the subject asset. Ownership rights are generally set out in legal documents and include, according to the jurisdiction involved, patents, trademarks, and copyrights. Ownership rights and conditions may be set out in an agreement or exchange of correspondence and may or may not be transferable to a new owner.

3.10 Although similar intangible assets within the same class will share some characteristics with one another, they will also have differentiating characteristics that will vary according by type of intangible asset but may include factors such as:

- precise functionality
- specific taste
- life
- geographical region of use
- ownership rights, including ability to exploit the asset for different purposes

3.11 The heterogeneous nature of intangible assets means that it is rarely possible to find market evidence of transactions involving identical assets. Usually the only available evidence is in respect of assets that are similar, but not identical.

3.12 Another important factor is to determine the life of an intangible asset. This may be a finite period limited by either contract or typical life cycles in the sector; other assets may effectively have an infinite live. Determining the life will include consideration of legal, technological or functional and economic factors. For instance, an asset comprising a drug patent may have a remaining legal life of five years before expiry of the patent, but a competitor drug with expected improved efficacy may be expected to reach the market in three years. This might cause the remaining life of the first to be assessed as only three years, being the lower of the remaining legal and economic lives.

4 *Valuation approaches and methods*

4.1 All intangible asset valuation methods fall within one of the three fundamental valuation approaches identified in Section 9 of *"Concepts Fundamental to Generally Accepted Valuation Principles"* IVS 2007 i.e.

- the market comparison approach[1]
- the income capitalisation approach; and
- the cost approach

4.2 The choice of valuation approach may be dictated by the required valuation objective, or *basis of valuation,* see IVS 1, 'Market Value', or IVS 2, 'Bases Other than Market Value'.

4.3 It may be appropriate to consider more than one approach and within each approach there may be different methods available. When undertaking any valuation where the objective is to estimate a market price, the role of the valuer is to adopt the approach(es) and method(s) that most closely match those that would be used by the parties to the hypothetical transaction. Understanding the nature of the market for the subject intangible asset is generally critical to determining the most appropriate valuation approach.

4.4 This section of the Guidance Note considers the different valuation methods commonly used for valuing intangible assets, together with the valuation inputs, i.e. parameters in respect of which assumptions must be made, usually associated with each of these valuation methods. These inputs are discussed in more detail in Section 5.

[1] Existing IVS refer to the "sales" comparison approach. However, it is customary in valuing intangible assets to refer to the "market" rather than sales comparison due to the relative scarcity of actual sales involving identical or similar assets. However, the slight difference in terminology does not imply any difference of approach; the techniques of observation and adjustment are identical and the terms should be considered synonymous except where indicated to the contrary.

Market participants and entity-specific factors

4.5 In undertaking a market-based valuation, the factual circumstances of the actual owner are not relevant because the willing seller is a hypothetical entity with the attributes of a typical market participant. The conceptual framework for Market Value, set out in IVS 1, excludes any element of special value or any element of value that would not be available to the generality of market participants.

4.6 Thus, factors that are specific to an entity and not available to market participants generally should be excluded from the inputs used in a market-based valuation. Examples of entity-specific factors that may not be available to the generality of market participants include:

- additional value derived from the existence or creation of a portfolio of similar intangible assets ;
- synergies between the intangible asset and other assets owned by the entity;
- legal rights or restrictions;
- tax benefits or tax burdens;
- the ability to use a brand name globally rather than in a specific geographic area;
- the ability to sell a piece of software in the business-to-business, B2B, as well as business-to-consumer, B2C, market; and
- specific cost and revenue synergies.

Whether factors such as these are specific to the entity or would be available to others in the market generally needs to be determined on a case by case basis.

4.7 If the valuation objective is not market value but to reflect the value of an asset to a specific owner, it follows that entity-specific factors should be reflected. Examples of situations in which the values to a specific owner may be required include:

- testing intangible assets for impairment under IFRSs by reference to their value in use.(see GN16)
- to support investment decisions.
- reviewing the performance of an asset.

Aggregation

4.8 Although it may sometimes be appropriate and possible to value an intangible asset on a stand-alone basis, in other cases it may be either impossible or impractical to value an intangible asset other than in conjunction with other tangible or intangible assets. The valuer should document clearly in the valuation report whether an intangible asset has been valued on a stand-alone basis or in conjunction with other assets. If the latter is the case, the valuer should explain why it was necessary to aggregate the subject intangible asset with other asset(s) for valuation purposes and describe clearly the asset(s) with which the subject intangible asset has been aggregated.

[Market] Comparison approach

4.9 Valuation methods that use the comparison approach determine the value of an intangible asset by reference to market activity, e.g. transaction bids or offers involving identical or similar assets.

4.10 An example of the comparison approach is the market transactions method, which determines the value of an asset by reference to transaction prices, or 'valuation multiples' implicit in the transaction prices, of identical or similar assets.

4.11 A valuation multiple is a multiple determined by dividing the transaction price of an asset by a financial parameter, such as historical or prospective turnover or profit at a given level. Some of the valuation multiples that are used in practice in the valuation of intangible assets are calculated as transaction price divided by:

- turnover generated by an intangible asset;
- profit contribution after deduction of certain costs, such as marketing costs; and
- earnings before Interest and Tax, (EBIT) or Earnings before Interest, Tax, Depreciation and Amortisation, (EBITDA).

4.12 Valuation multiples are applied to the corresponding financial parameter of the subject asset in order to value it. For instance, if a valuation multiple of 1.5 times historical turnover is identified from a market transaction and the subject asset had historical turnover of Currency Unit 'CU' 50,000, the value indicated by use of the valuation multiple would be:

1.5 *CU 50,000 = CU 75,000.

4.13 The required inputs for the market transactions method are:

- prices and/or valuation multiples in respect of identical or similar intangible assets;
- adjustments as required to such transaction prices or valuation multiples, to reflect the differentiating characteristics of the subject asset and the assets involved in the transactions.

4.14 There are practical difficulties that restrict the use of this method for intangible assets. Often, there are either very few or no transactions involving identical or similar assets for which price information is available. Even where transactions can be identified and information regarding prices paid is available, it can be difficult to determine the appropriate adjustments either to the prices or the valuation multiples necessary to reflect the differentiating characteristics of the subject intangible asset and the assets involved in the transactions. In practice, such adjustments may only be determinable at a qualitative, rather than quantitative, level. For example:

- the brand being valued may be considered to command a more dominant position in the market than those involved in the transactions; or
- a drug patent being valued may have greater efficacy and fewer side effects than those involved in the transactions.

4.15 The difficulties described above may restrict the reliability of the market transactions method in the valuation of intangible assets. Consequently, in practice this method is often used as a supporting method to cross-check the valuation results obtained by applying another valuation method, than as the primary valuation method.

Income capitalisation approach

4.16 Valuation methods that use the income capitalisation approach determine the value of an intangible asset, by reference to the capitalised value of income, cash flows or cost savings that could be actually or hypothetically be achieved by a market participant owning the asset.

4.18 Thus, any income capitalisation method is heavily reliant on prospective financial information, (PFI). PFI can be any type of forecast financial data and, hence, includes forecast:

- turnover
- gross profit, operating profit and net profit
- profits before and after tax
- cash flows before or after interest and/or tax
- length of remaining useful life

4.19 The principal intangible asset valuation methods that use the income capitalisation approach are:

- relief-from-royalty method, (sometimes known as royalty savings method);
- premium profits method, (sometimes know as incremental income method); and
- excess earnings method.

4.20 Each of these methods involve the capitalisation of forecast cash flows using either discounted cash flow techniques or, in simple cases, the application of a valuation multiple.

4.21 For further guidance on the application of the discounted cash flow method see IVS GN9 *Discounted Cash Flow Analysis for Market Valuations and Investment Analysis.* As an alternative to using discounted cash flow techniques, cash flows and income can be capitalised using multiples, particularly in simplified examples.

4.22 In addition to capitalising the income, cash-flows or cost savings that may be derived from use of the asset, it maybe appropriate to increase the intangible asset value to take account of any tax relief available on amortisation of the capitalised asset.. Such an adjustment, known as the tax amortisation benefit, reflects that the income derivable from an asset includes not only the income directly achievable from its use but also the reduction in tax payable by a business using the asset.

4.23 If estimating the Market Value an adjustment to the cash flows for tax amortisation should be made only if this benefit would be available to market participants generally.

4.24 When performing a valuation under a basis other than market value, a TAB adjustment should be made if availability of amortisation would be consistent with the basis of valuation. Thus, if an entity-specific valuation is being performed, a TAB adjustment should be included only if tax amortisation would be available to the specific entity concerned.

Relief-from-royalty, or royalty savings, method

4.25 The relief-from-royalty method determines the value of an intangible asset by reference to the capitalised value of the hypothetical royalty payments that would be saved through owning the asset, as compared with licensing the asset from a third party. It involves estimating the total royalty payments that would need to be made over the asset's life, by a hypothetical licensee to a hypothetical licensor. The hypothetical royalty payments over the life of the asset are adjusted for tax and discounted to present value and then are capitalised.

4.26 Royalty rates are typically applied as a percentage of the turnover expected to be generated when using the asset. In some cases, royalty payments may include an upfront lump sum in addition to periodic amounts based on turnover or some other financial parameter.

4.27 The following valuation inputs are required to apply the relief-from-royalty method:

- the royalty rate and corresponding financial parameter, such as a percentage of turnover, that would hypothetically be paid in an arm's length transaction by a willing licensee to a willing licensor for the rights to use the subject intangible asset;
- projections for the financial parameter, such as turnover, that the royalty rate would be applied to over the life of the asset together with an estimate of the life of the asset;
- rate at which tax relief would be obtainable on hypothetical royalty payments;
- The cost of marketing and any other costs that would be borne by a licensee in utilising the asset.
- a discount rate to enable estimated periodic royalty payments to be brought to a single capital value; or
- in simple cases a capitalisation multiple to apply to constant cash flows.

4.28 Royalty rates can often vary significantly in the market for apparently similar assets. It is often prudent to cross check the assumed royalty input by reference to the operating margin that a typical operator would require from sales generated from use of the asset.

Premium profits, or incremental income, method

4.29 The premium profits method involves comparing the forecast profit stream or cash flows that would be earned by a business using the intangible asset with those that would be earned by a business that does not use the asset. The forecast incremental profits or cash flows achievable through use of the asset are then computed. Forecast periodic amounts are capitalised through use of either a suitable discount factor or suitable capitalisation multiple.

4.30 Depending on the basis of valuation required, the forecast cash flows of a business using or not using the asset may or may not be permitted to include entity specific factors that are not available to the generality of market participants.

4.31 Some or all of the following valuation inputs are required to apply the premium profits method:

- forecast periodic profit, cost savings or cash flows expected to be generated by a market participant using the intangible asset;
- forecast periodic profit, cost savings or cash flows expected to be generated by a market participant not using the intangible asset;
- an appropriate capitalisation multiple or discount rate to capitalise forecast periodic profit or cash flows.

4.32 The method can be used to value both intangible assets whose use will save costs and those whose use will generate additional profit.

4.33 The following is a simple example of use of the premium profits method. Suppose a brand is being valued and the profit after tax in the most recent reporting period for the business using the brand was CU12,000. A comparable business is identified that does not use a brand and its profit after tax in the most recent reporting period was CU10,000. Thus, the incremental post-tax profit achieved through using the brand was CU2,000. This incremental profit could be capitalised using an appropriate multiple drawn from price earning ratios that are typical in the market for similar types of business.

Excess earnings method

4.34 The excess earnings method determines the value of an intangible asset as the present value of the cash flows attributable to the subject intangible asset after excluding the proportion of the cash flows that are attributable to other assets.

4.35 The excess earnings method can either be applied using a single period of forecast cash flows – the "single-period excess earnings method" or using several periods of forecast cash flows – the 'multi-period excess earnings method'. In practice because an intangible asset will normally bring monetary benefits over an extended period, the multi-period excess earnings method is more commonly used.

4.36 The method involves forecasting the cash flows expected to arise from the business or businesses that use the subject intangible asset. From this forecast of cash flows, a deduction is made in respect of the contribution to the cash flows that is made by assets, tangible, intangible and financial, other than the subject intangible asset.

4.37 The effects of goodwill should also be excluded from the intangible asset value. This can be done by ensuring that:

- the forecast cash flows are reflected in the projection only to the extent that it is expected to arise from the assets in existence at the valuation date; and
- adjustments to the cash flows are made for components of goodwill that contribute to value, such as the workforce and other factors giving rise to future economic benefits that are not identifiable intangible assets.

4.38 Forecast cash flows are brought to a capital value by application of present value techniques and a suitable discount rate or, in simple cases, a capitalisation factor.

4.39 The contribution to cash flows made by assets other than the subject intangible asset is known as the 'contributory asset charge', 'CAC', or 'economic rent'. These contributory assets support the subject intangible asset in generating cash flows. The CAC is discussed further in Section 5, paragraphs 5.29 to 5.39.

4.40 In order to determine a fair return on or of a contributory asset, its value must be determined. Any subjectivity or uncertainty in estimating such fair values will restrict the reliability of the excess earnings method and should be considered when comparing the reliability of the excess earnings method with that of other available valuation methods.

4.41 The inputs required to apply the excess earnings method include:

- forecast cash flows obtainable from the business(es) to which the subject intangible asset contributes to cash flows – this will involve allocating both income and expenses appropriately to the smallest business or group of businesses of the entity that includes all the income derivable from the subject intangible asset;

- contributory asset charges in respect of all other assets in such business(es), including other intangible assets; and

- an appropriate discount rate, or capitalisation multiple, to enable expected cash flows attributable to the subject intangible asset alone to be brought to a capital value.

4.42 Typically, the types of intangible asset that are valued using the excess earnings method are those that contribute to cash flows in combination with other assets in a group and for which alternative valuation methods are not available.

4.43 The method is frequently used in practice to value in-process research and development, or 'IPR&D', projects. These are difficult to value by other methods. As each IPR&D project is likely to be unique, it is unlikely that there will be market transactions in similar assets so a comparison approach is unlikely to be possible. The nature of an IPR&D project is that additional development time and costs are anticipated prior to the asset generating cash flows (or cost savings). A discounted cash flow exercise, such as multi-period excess earnings, can be adapted to reflect these costs prior to the asset generating cash flows (or cost savings), whereas such adaptation would not be possible with either the relief-from-royalty or premium profits methods.

4.44 The method is also frequently used in practice to value customer relationships or customer contracts. Again, there are rarely market transactions in similar assets for which price information is available so a market comparison valuation method is unlikely to be possible. Also, it is difficult to apply relief-from-royalty to such assets as these assets are not leased in the market and so there is no data available on which to base royalty rates. Similarly, it is not possible to apply the premium profits method as it would be difficult to find a comparable business that did not have customer relationships.

Cost approach

4.45 The cost approach, often known as the depreciated replacement cost approach, determines the value of an intangible asset by calculating the cost of replacing it with an asset with similar or identical service capacity. This provides a ceiling or maximum for the value of certain intangible assets, as a rational purchaser would not pay more for an asset than he would need to pay to replace its service capacity. Adjustments, including that in respect of depreciation, may be required to reflect differences between the cost of replacing the asset with one with similar service capacity and replacing it with one with the depreciated service capacity of the subject asset.

4.46 Because the cost of creating an asset can only ever represent a maximum that a buyer would pay for one that was "ready made", and because depreciation adjustments to reflect the service potential of the subject asset compared with a new replacement are often subjective, this approach is mainly used for internally generated intangible assets that have no identifiable income streams or other economic benefits.

4.47 To apply the cost approach, the replacement cost of a similar asset or one with similar service potential must be estimated. This may be done either by:

- identifying the price of a replacement asset in the market; or
- by determining the cost of developing or building a similar asset.

4.48 In practice, there are only a few types of intangible asset for which either of these can be estimated.

- The method is sometimes applied to software as the price of software with [the same or] similar service capacity can sometimes be obtained in the market.
- It is sometimes applied to web sites as it may be possible to estimate the cost of constructing the web site.
- It is sometimes applied to value the intangible benefit of the workforce through determining the cost of building up the workforce. Although the workforce is not usually considered to be an identifiable intangible asset because the owning entity does not control economic benefits flowing from it and it may be difficult to separate from the business, a contributory asset charge is required in respect of the workforce when applying the excess earnings method.

4.49 The cost approach is not suitable for valuing intangible assets for which there are no comparable assets with equivalent service potential for which a price can be obtained. For example, the cost of developing a brand or publishing title is hard to determine. There is frequently no set project to develop such assets and development may take many years. The cost of development will often bear no relationship to the amount that could be realised in an exchange transaction. This is because a brand or publishing title may have a value significantly greater or smaller than its development cost.

4.50 The valuation inputs required to apply the replacement cost method include some or all of the following factors:

- the cost of developing or purchasing an identical asset with the same production or service potential;
- the cost of developing or purchasing a similar asset with the same or similar production or service potential;
- in the case of the cost of a similar, rather than identical, asset with the same or similar production or service potential being identified, the adjustments required, including amortisation if appropriate, to that cost in order to reflect the specific characteristics of the subject asset; and
- the expected difference between the cost price of the replacement asset and the exchange price of the subject asset – as value is a measure of the amount that could be obtained in an exchange transaction.

5 *Valuation inputs*

5.1 This section examines the eight most frequently used valuation inputs identified in the various valuation methods discussed in the previous section. These are:

1. prospective financial information;
2. comparable transaction prices and implied valuation multiples;
3. royalty rates;
4. premium profits;
5. contributory asset charges;
6. discount rates;
7. capitalisation multiples; and
8. replacement cost

5.2 This section provides guidance on how these valuation inputs may be determined. The degree to which different inputs will require to be investigated or verified by the valuer will depend on the purpose of the valuation and the scope of the valuation exercise. In practice, there may be further inputs – it is not possible to provide an exhaustive list.

Prospective financial information, (PFI)

5.3 All the intangible asset valuation methods under the income capitalisation approach require PFI for some of their inputs. The income stream capitalised will relate to financial parameters such as turnover, operating profit, cash flow or some other measure. Estimates of these financial parameters are critical to the reliability of the resulting valuation.

5.4 PFI is often required in application of a market comparison approach also, as valuation multiples are frequently applied to prospective financial parameters as well as to historic financial parameters.

5.5 There is a link between the basis under which the PFI is forecast and the basis under which an appropriate discount rate is determined.

5.5.1 Under the “traditional” or “implicit” approach, the forecast cash flows reflect the current cash flows and are discounted at a rate commensurate with the risk attaching to the underlying asset.

5.5.2 Under the “expected” or “explicit” approach, express assumptions are built into the forecast cash flows to reflect the performance risk of the asset and therefore these are discounted at a rate that reflects the time value of money only.

5.6 When making estimates of PFI, it is important to be clear which approach is being used, so that risks are not double counted or missed. The implications on the selection of an appropriate discount rate are discussed in paragraph 5.40 et seq below.

5.7 PFI should be estimated with respect to factors such as:

- turnover anticipated through use of the asset and the forecast share of the market;
- historic profit margins achieved and any variations from those margins anticipated taking account of market expectations;
- tax charges on income derived from the asset;
- working capital and capital expenditure requirements of the business using the asset; and
- growth rates after the explicit forecast period appropriate to the asset’s expected life reflecting the industry involved, the economies involved and market expectations to provide realism to management’s estimates.

The assumptions behind these inputs should be documented in the valuation report together with their source.

5.8 The forecast period needs to be assessed appropriately so that it is consistent with the expected useful life of the subject intangible asset. As the life of an intangible asset may be finite or assumed to be infinite, forecast cash flows may be for a finite period or may run into perpetuity.

5.9 PFI obtained from different sources should be “benchmarked” to assess its appropriateness for use in the valuation. Benchmarking is the process of performing consistency checks on the PFI assumptions. When performing valuations under a market value basis, this will include comparing the inputs with data derived from the market to assess and improve their accuracy and reliability.

5.10 For PFI being used to determine the market value of intangible assets, growth rates, margins, tax rates, working capital and capital expenditure, benchmarking should include a comparison with the corresponding data from market participants.

5.11 Other factors affecting PFI inputs may include economic and political outlook and related government policy. Matters such as currency exchange rates, inflation and interest rates may affect intangible assets that operate in different economic environments quite differently. Consideration should be given to how such factors affect the specific market and industry in which the subject asset is being valued.

5.12 When cash flows are forecast into perpetuity, specific consideration should be given to the growth rates used. These should not exceed the long-term average growth rates for the products, industries, country or countries involved, unless a higher growth rate can be justified.

5.13 When using PFI to determine the value of an intangible asset, a sensitivity analysis of the resulting asset value should be performed to assess the impact of possible variations in the underlying assumptions. Those elements of PFI to which the resulting asset value is most sensitive, should be reviewed to ensure that the assumptions underlying them are as robust as possible with all available relevant factors being reflected.

Comparable transaction prices

5.14 If the rare cases in which the subject asset is identical to others traded in an active market, obtaining a reliable market price is straightforward. The market price in the active market is the only input required in such cases. No adjustments will be required to the market price.

5.15 Because of the heterogeneous nature of most intangible assets, information from comparable transactions will usually involve similar rather than identical assets. In some cases the nature of the comparable transaction may also be different from the valuation objective, e.g. it may relate to a transaction between market participants when an entity specific based valuation such as value in use is required. In spite of these differences the information from these transactions may still be relevant although a benchmarking exercise may be needed to address:

- differentiating characteristics of the assets involved including geographical coverage, functionality, market coverage or markets accessed (for example one asset may be in the business-to-business, (B2B), market and the other in the business-to-consumer, (B2C) market.);
- specific purchaser or seller factors that might impact price such as a forced sale or related party transaction as part of group restructuring; and
- differences in the market between the comparable transaction and the valuation date.

5.16 It is often the case that full transaction information is difficult or impossible to obtain and may be subject to confidentiality. While the transaction price may be known, the valuer may not know the detailed terms, for example whether warranties and indemnities were given by the seller, whether incentives were involved, or what impact taxation planning had on the transaction.

5.17 Comparable transactions may produce direct evidence of price or be analysed to provide valuation multiples as described earlier. The output from the benchmarking exercise should be to determine whether the identified factors would result in the price in the comparable transaction being higher or lower than the price in a hypothetical transaction involving the subject asset. If possible, any increase or decrease should be quantified – if this is not possible, as much qualitative information as available should be documented, such as whether the factor is likely to 'significantly' or 'slightly' increase value as compared with the asset transacted. .

Royalty rates or amounts

5.18 Under the relief-from-royalty method, a key input is the hypothetical royalty rate that would be paid by a willing licensee to a willing licensor to license the asset over its useful life. For valuations under the market value basis, lessor and lessee should be market participants as regards their ability to lease rather than buy or sell the asset.

5.19 Royalty rates may be obtained by reference to any existing or previous arrangements in which the subject asset was licensed or by reference to licensing arrangements in the market for identical or similar assets.

5.20 Any royalty information obtained should be adjusted to reflect the differences between the comparable royalty arrangement and the subject asset. Factors to benchmark when comparing the subject asset and other royalty agreements include:

- specific licensor or licensee factors that might impact the royalty rate such as their being related parties;
- exclusivity terms;
- whether the licensor or licensee has responsibility for certain costs, such as marketing and advertising;
- licence inception date and period of effect;
- duration of licence; and
- differentiating characteristics such as market position, geographical coverage, functionality, whether they are used in connection with B2B or B2C products etc.

5.21 When performing royalty cash flow calculations, maintenance and other support expenditure must be treated consistently. Thus, if the licensor is responsible for maintenance expenditure, for example advertising or maintenance research and development, the royalty rate should reflect this as should the royalty cash flows. Alternatively if maintenance expenditure is not included in the royalty rate, it should also be excluded from the royalty cash flows. Similarly tax must be treated consistently in the royalty cash flows.

5.22 Reasonableness checks should also be performed in respect of the selected royalty rate. One such check compares the total profit at a particular level, such as gross or operating profit, and how much of that profit would accrue to each of licensee and licensor if a selected royalty rate were used in determination of the licence fee. The reasonableness of such a profit split can then be reviewed.

5.23 If the resulting profit splits are significantly different from the ranges indicated by market evidence:

- this may be explicable by reference to specific factors – for instance, the subject asset may be especially complex and, hence, expected to earn a higher than normal return for the licensor;
- it may be necessary to reconsider whether the selected royalty rate is appropriate; or
- depending on the basis of valuation being adopted, a royalty rate might be appropriate that is different from that adopted by market participants.

Premium profits

5.24 The key inputs in the premium profits method of valuation are the forecast premium profits, which are a type of PFI. Forecasts of the cash flows achievable both with and without the subject intangible asset should be made by reference to:

- activities of the owning entity;
- any entities using similar or identical intangible assets for which information is available publicly;
- any proprietary databases of the valuer; and
- other research as available.

5.25 Examples of where different profits may be generated with or without an asset include:

- a beverage being sold by the same entity under both a branded and non-branded label.
- a non-compete agreement creating different projected cash flows.

5.26 Where such data is obtained from the owning entity it should be tested or benchmarked against other data in the market. Depending on the basis of valuation required, adjustments may be required in respect of entity-specific factors in the forecasts.

5.27 Comparability factors to benchmark include the extent to which the profit or cash flow forecast, excluding use of the intangible asset, is tainted to any degree through reliance on another intangible asset. This could happen, for instance, through the comparable profits being reliant on an ‘own-name’ brand rather than no brand. In such cases, the identified premium profit and resulting value attributable to the intangible subject asset would be understated.

5.28 Account also needs to be taken of any differences in the level of investment that may exist between an apparently comparable brand and the subject. A branded product may produce higher gross profits than an unbranded product due to higher selling price. But sales of the branded product may require advertising and marketing

expenses that the unbranded product does not. Similarly, a new manufacturing technology may reduce manufacturing costs, but require the purchase of additional machinery. The return on the additional machinery needs to be considered in the valuation of the technology.

Contributory asset charges

5.29 When applying the excess earnings approach to the valuation of a specific asset, the contribution of other assets to the cash flow being analysed have to be eliminated. This is done by deducting a contributory asset charge (CAC) in respect of such other assets. Such charges are a type of PFI.

- If cash flows are forecast on a post-tax basis, CACs should be determined on a post-tax basis.

- If cash flows are forecast on a pre-tax basis, CACs should be determined on a pre-tax basis.

5.30 The determination of CACs generally comprises three steps:

- identification of the assets contributing to the cash flows;

- measurement of the fair values of such assets; and

- determination of an appropriate fair return on the capital value of such assets.

5.31 The underlying principles are that:

- CACs should be made for all assets including elements of goodwill that contribute to the generation of cash flows; and

- if an asset for which a CAC is required is involved in the generation of more than one line of business, its CAC should be spread appropriately over the different lines of business involved.

5.32 Assets for which CACs are typically made include working capital, fixed assets, intangible assets other than the subject intangible asset, and workforce-based intangible assets. Care needs to be taken to ensure that there is no double counting between charges in the profit and loss account and the CACs made, and similarly that no CACs are omitted.

5.33 CACs are generally computed as a fair return on and of the value of the underlying asset.

- The return on a contributory asset is the investment return an investor would require on the asset. This return that an investor would require is computed with respect to the fair value of the asset.

- The return of a contributory asset is a recovery of the original investment in respect of assets that deteriorate over time. Thus, in the case of a tangible fixed asset, the return of such asset would be represented by its depreciation charge.

5.34 For tangible assets, a fair return on and of the asset is the amount that would be required to be paid for use of the asset. This might be determinable from leasing or hire purchase arrangements which would provide a composite figure for returns on and of the asset.

5.35 Alternatively, a notional depreciation charge or apportioned capital expenditure charge (as excess earnings method uses discounted cash flows, depreciation should be added back initially as a non-cash charge), could be used as a surrogate for the return of the asset. A return on the asset could then be determined by reference to interest rates that would be charged in the market to purchase the asset.

5.36 In respect of working capital, care must be taken by reference to whether interest charges are deducted in the cash flow forecasts. Typically, interest charges are excluded from cash flows but are reflected through discounting at a cost of capital that reflects the extent of debt financing for tangible and intangible assets. In order to reflect an additional fair return on working capital, interest rates on bank lending with an appropriate term should be used. As working capital is not an asset that deteriorates over time, i.e. is not a 'wasting' asset, returns of working capital are not required as CACs.

5.37 In respect of the workforce, there is a cost associated with getting this in place and a return on the workforce charge is required in that respect. Returns on the workforce can be determined as a return charged on the fair value of the workforce asset. The workforce asset is usually valued using a cost approach, as described in paragraph 4.45 et seq. above, and a fair return on this capital value is usually determined by reference to the cost of capital for the business employing the workforce.

5.38 A fair return on an intangible asset can be by reference to a hypothetical royalty rate that would be charged to lease the asset. Alternatively, if the asset were one that could be used in isolation by a business, the return on the asset could be determined by reference to a hypothetical cost of capital.

5.39 A check should be performed on the reasonableness of all CACs used. The weighted average rate of return on assets, (WARA), should be calculated by multiplying the CAC for each asset by its fair value and summing the results. The sum of these computations should be divided by the total fair value of all the assets used in the business and the result should approximate to the WACC for the entity.

Discount rates

5.40 When applying an income capitalisation method, forecast periodic amounts are required to be brought to a single capital amount either by adding periodic amounts discounted for risk and the time cost of money or by applying a capitalisation multiple to a constant amount. Capitalisation of a constant amount can be viewed as a simplification of a discounted cash flow (DCF) exercise.

5.41 In most DCF exercises, amounts forecast for different future periods are different and do not grow at a constant rate from previous periods. Thus, they must be discounted using specific appropriate discount factors. In some DCF exercises, however, amounts forecast for different future periods grow at a constant rate from previous periods. In such cases, they may be brought to a single capital value through the use of a capitalisation multiple.

5.42 As discussed in paragraphs 5.5 et seq. above, the appropriate discount rate to use depends upon whether the traditional (implicit) approach or the expected value (explicit) model has been used.

5.43 A discount rate under the traditional approach should reflect both the time value of money and the risks attaching to the single asset being valued. This is a different rate from that attaching to the business or businesses that use the asset. The following methods are available to determine this discount rate:

- the 'build-up' approach that attaches premia or discounts to a rate observed in the market to reflect different risks; and
- direct observation in the market of the cost of capital for a business that relies only on the subject asset or a similar intangible asset.

5.44 In applying the build-up approach, the starting point is often to find the weighted average cost of capital, 'WACC', for a typical business in the sector. The WACC is the weighted average of the cost of debt and the cost of equity.

5.45 In practice, it is usually difficult to observe costs of capital in the market for similar assets as most businesses rely on more assets than just the subject asset. However, it may be possible to use rates from the market as reasonableness cross-checks of results from application of the build-up method.

5.46 Under the expected value approach, the discount rate reflects only the time value of money as cash flow risks are explicitly reflected in the model. If all risks can be reflected in the model then it may be appropriate to use a risk-free discount rate, such as government bonds with maturity dates reflecting the life of the subject asset. However, it is rare for all risks to be capable of elimination in the cash flow projections, and therefore most investors in an intangible asset would expect a return above that of "risk free" government bonds.

Capitalisation multiples

5.47 As noted earlier, when cash flows for different periods grow at a constant amount, they can be brought to a single capital amount either through applying an appropriate capitalisation multiple.

5.48 Capitalisation multiples can be applied to forecast cash flows either:

- by use of valuation multiples, such as price/earnings multiples, for similar assets in the market – this information is available only rarely; or
- by adjusting the discount rate obtained above to reflect the life of the subject asset.

Replacement cost

5.49 The inputs when using the replacement cost method are discussed at 4.50 above. A benchmarking exercise should be performed to assess the suitability of the replacement cost information to include:

- differentiating characteristics of the replacement asset measured and the subject asset, such as service and production capacity;

- date at which replacement cost has been estimated as compared with valuation date.

5.50 The extent of adjustments to replacement cost obtained from research and any preference for one measure of cost over another, if more than one has been found, should be documented.

6 *Selection of valuation methods*

6.1 Except in rare cases where prices for an identical asset can be observed in the market at the valuation date, it will be necessary to consider the most appropriate method or methods to use taking into account both the reliability of the method and the robustness of the required valuation inputs in the context of application of the method. The valuation method or methods used and the reason why they are considered appropriate should normally be documented in the Valuation Report.

6.2 Sufficient data may be available that the required parameters to apply a secondary method could be deduced, from the value for the intangible asset calculated under the primary method. This is sometimes called 'reverse engineering'. For instance:

- if an intangible asset is valued using relief-from-royalty or premium profits as the primary method, the implied multiples of, say, turnover and contribution after marketing charges could be deduced ('reverse engineered') and compared with those from identified comparable market transactions;

- if an intangible asset is valued using multi-period excess earnings or replacement cost as the primary method, implied royalty rates could be deduced that would have applied if relief-from-royalty were used; such rates could then be considered for reasonableness.

6.3 In the absence of an active market in identical intangible assets, many assets are valued primarily using an income capitalisation method. This is because qualitative and subjective adjustments are often required to apply transaction data from non identical assets, which adversely affects reliability.

6.4 However, the income capitalisation approach itself can be subject to restricted reliability, given the large number of inputs that may be required to apply it. This can be especially pertinent if any given method is particularly sensitive to an assumption that is difficult to estimate reliably.

6.5 Cross-checks, using another valuation method, of the results of valuing intangible assets under an income capitalisation method should be used, wherever possible, to increase the reliability of any specific method.

6.6 The following table shows a matrix of valuation methods that could be available for a brand:

Data type	Availability	Reliability of data	Impact on valuation methods available
Comparable transaction prices and valuation multiples	Two transactions in similar asset available – each more than one year before the valuation date	Low - assets are not closely comparable	Market transactions method available as supporting, not primary, method
Prospective financial information	Forecasts could be made based on the subject entity's expectations adjusted to exclude entity-specific factors	Medium/high –the subject entity is a market participant and there are few entity-specific factors to adjust for	Income capitalisation methods may be available depending on other data required
Royalty rates	Details of 10 comparable licensing arrangements are available	High	Relief-from-royalty method could be used as primary method
Premium profits	A comparable unbranded business is identified in the market but it would not be possible to obtain a forecast of PFI for this business	Not available	Premium profits method is not available
Capitalisation multiples	Price/earnings multiples of other branded businesses are available	Medium – some adjustments required between market P/Es and subject brand capitalisation multiple	Multiples could be used for market transactions method or income capitalisation approach
Discount rates	Could be calculated using build-up method by reference to WACC for quoted companies using similar brands and the WACC of the subject entity	High	Can use an income capitalisation approach
Contributory asset charges	The capital value of other assets contributing to cash flows is needed. However, one of those other assets is customer relationships – these are not known.	Not available as one of the inputs cannot be estimated	Multi-period excess earnings method is not available as value of customer relationships is not known.
Replacement cost	No replacement evidence available	Not available	Cost approach not available

6.7 In the example above, relief-from-royalty, with cash flows being capitalised by use of discounting periodic amounts rather than by application of a capitalisation multiple, would be indicated as the primary method, with a supporting cross check using the market transactions method. When using the sales comparison method to cross check the results of an income capitalisation method, the result from application of the sales comparison method should be cross checked against the post TAB income capitalisation result.

6.8 The Valuation Report should include an explanation of differences in valuation results between the primary method and any secondary methods or cross-checks applied. This explanation should highlight the valuation inputs that are perceived as being the most and least robust and, hence, the relative reliability of the different results obtained.

6.9 In summary, the order of reliability in which valuation methods should be applied is as follows:

1. Comparisons with other market transactions of identical or similar assets traded in the market; and thereafter:

2. either a cost or income capitalisation method as the primary method depending on the availability of reliable data to support application of the method; and

3. where possible, the results obtained using the primary method should be cross-checked for reasonableness against another valuation method.

6.6 Whenever data is available without undue cost or effort that would allow an intangible asset to be valued using alternative methods, it is good practice to undertake valuations using those different methods in order to cross check the result of the primary method selected. Careful judgement is required to decide how much weight to give to each method if they result in different conclusions.

7 *Reporting the Valuation*

7.1 A valuation report should be prepared in accordance with IVS 3 *Valuation Reporting.*

8 *Effective Date*

8.1 This International Valuation Guidance Note is effective from [x] 2009.

Glossary of Abbreviations

CAC	Contributory asset charge
CAPM	Capital Asset Pricing Model
CU	Currency unit
DCF	Discounted cash flow
EBIT	Earnings before interest and tax
EBITDA	Earnings before interest, tax, depreciation and amortisation
GN	Guidance Note
IFRS	International Financial Reporting Standard
IPR&D	In-process Research and Development
IVS	International Valuation Standard
PFI	Prospective financial information
US GAAP	US Generally Accepted Accounting Principles
WACC	Weighted average cost of capital
WARA	Weighted average return on assets