International Valuation Guidance Note No. 4

Valuation of Intangible Assets

1.0 Introduction

1.1 The International Valuation Standards Committee (IVSC) adopted this Guidance Note (GN) to improve the consistency and quality of intangible asset valuations among the international community for the benefit of users of financial statements and users of intangible asset valuations.

1.2 Intangible asset valuations are commonly sought and performed on the *Market Value* basis of valuation applying the provisions of International Valuation Standard 1 (IVS 1). Where other bases of valuation are used with proper explanation and disclosure, the provisions of IVS 2 are applied.

1.3 In general, the concepts, processes, and methods applied in the valuation of intangible assets are the same as those for other types of valuations. Certain terms may have different meanings or uses. Those differences become important disclosures wherever they are used. This GN sets forth important definitions used in valuations of intangible assets.

1.4 Care should be taken by Valuers and users of valuation services to distinguish between the value of individual, identifiable intangible assets and going concern considerations, including those encountered in the valuation of real property interests. An example of the latter is valuations of property with trading potential.

2.0 Scope

2.1 This GN is provided to assist in the course of rendering or using valuations of intangible assets.

2.2 In addition to the elements that are common to other GNs to the International Valuation Standards, this GN contains a more expansive discussion of the intangible asset valuation process. This is included to typify what is commonly involved in valuations of intangible assets and to provide a basis of comparison with other types of valuations, but the discussion should not be considered as either mandatory or limiting except as provided in this GN or otherwise in the IVS.

2.3 Because other basic valuation principles, the International Valuation Standards, and Guidance Notes are also applicable to valuations of intangible assets, this GN should be understood to incorporate all other applicable portions of the IVS.

3.0 Definitions

3.1 *Book Value*

3.1.1 With respect to assets, the capitalised cost of an asset less accumulated depreciation, depletion, or amortisation as it appears on the account books of the business.

3.1.2 With respect to a business enterprise/entity, the difference between total assets (net of depreciation, depletion, and amortisation) and total liabilities of a business as they appear on the balance sheet. In this case, *book value* is synonymous with net *book value, net worth,* and *shareholder's equity.*

3.2 *Business Enterprise/Entity.* A commercial, industrial, or service organisation pursuing an economic activity.

3.3 *Capitalisation*

3.3.1 The conversion of income into value

3.3.2 The capital structure of a business

3.3.3 The recognition of an expenditure as a capital asset rather than a periodic expense

3.4 *Capitalisation Factor.* Any multiple or divisor used to convert income into value.

3.5 *Capitalisation Rate*. Any divisor (usually expressed as a percentage) that is used to convert income into value.

3.6 *Cash Flow*

3.6.1 *Gross Cash Flow.* Net income after taxes plus non-cash items such as depreciation and amortisation equals *gross cash flow.*

3.6.2 *Equity Net Cash Flow. Gross cash flow,* less additions to working capital (decreases are added), less capital expenditures, less decreases in invested capital debt principal, plus increases in invested capital debt principal equals *equity net cash flow.*

3.6.3 *Invested Capital Net Cash Flow. Equity net cash flow* plus interest payments net of tax adjustment less net increases in debt principal equals *invested capital net cash flow.*

3.7 *Discount Rate*. A rate of return used to convert a monetary sum, payable or receivable in the future, into present value. A weighted average of the discount rate applied to intangibles and the discount rate applied to tangibles should correlate with the weighted average cost of capital for the business.

3.8 *Economic Life*. The period over which property may be profitably used. Economic life may vary by State depending on the level of industrial development and regulatory atmosphere in each State.

3.9 *Effective Date*. The date as of which the Valuer's opinion of value applies. (Also referred to as Valuation Date, and/or As Of Date.)

3.10 *Enterprise*. See Business Enterprise/Entity.

3.11 *Going Concern*. An operating business.

3.12 *Going Concern Value*

3.12.1 The premise of value of a business, or of an interest therein, as an operating business.

3.12.2 Intangible elements of value in an operating business resulting from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place.

3.13 *Goodwill*. That intangible asset that arises as a result of name, reputation, customer patronage, location, products, or similar factors that generate economic benefits.

3.14 *Income Capitalisation Approach*. A general way of estimating a value indication of an intangible asset using one or more methods wherein a value is estimated by converting anticipated benefits into capital value.

3.15 *Intangible Assets*. Assets that manifest themselves by their economic properties. They do not have physical substance; they grant rights and privileges to their owner and usually generate income for their owner. Intangible Assets can be categorised as arising from *Rights, Relationships, Grouped Intangibles,* or *Intellectual Property.*

3.15.1 *Rights* exist according to the terms of a contract, written or unwritten, that is of economic benefit to the parties. Examples are supply contracts, distribution contracts, providing contracts, and licensing permits, among others.

3.15.2 *Relationships* between parties are normally non-contractual, can be short-lived, and can have great value to the parties. Examples are assembled workforce, customer relationships, supplier relationships, distributor relationships, and structural relationships between parties, among others.

3.15.3 *Grouped Intangibles* are the residual *intangible asset* value left after all identifiable *intangible assets* have been valued and deducted from total *intangible asset* value. Alternative concepts include patronage, excess earnings, and residual value. *Grouped intangibles* are often called *goodwill*. *Goodwill* has, at various times, been said to be the tendency for customers to return to a place of business, the extra income generated by a business over and above a fair return to the identified assets, and/or the extra value of the enterprise/entity as a whole over and above the aggregate value of its constituent identifiable assets.

3.15.4 *Intellectual Property* is a special classification of *intangible assets* because it is usually protected by law from unauthorised use by others. Examples are brand names, or tradenames; copyrights; patents; trademarks; trade secrets, or know-how; among others.

3.15.5 In general, the accounting profession limits the recognition of individual *intangible assets* to those that are commonly recognisable, have a statutory or contractual remaining life, and/or must be individually transferable and separable from the business.

3.16 *Intangible Property*. The rights and privileges granted to the owner of intangible assets.

3.17 *Legal Life*. The life of the *intangible assets* allowed by law.

3.18 *Market Approach*. A general way of estimating a value indication for an intangible asset using one or more methods that compare the subject to similar assets that have been sold.

3.19 *Market Value*. See IVS 1, para. 3.1.

3.20 *Rate of Return*. An amount of income (loss) and/or change in value realised or anticipated on an investment, expressed as a percentage of that investment.

3.21 *Replacement Cost New*. The current cost of a similar new item having the nearest equivalent utility as the item being appraised.

3.22 *Report Date*. The date of the Valuation Report. May be the same as or different from the valuation date.

3.23 *Reproduction Cost New*. The current cost of an identical new item.

3.24 *Valuation Approach*. In general, a way of estimating value using one or more specific valuation methods. (See *Asset Based Approach, Market Approach,* and *Income Capitalisation Approach* definitions.)

3.25 *Valuation Method*. Within valuation approaches, a specific way to estimate a value.

3.26 *Valuation Procedure*. The act, manner, and technique of performing the steps of a valuation method.

3.27 *Valuation Ratio*. A factor wherein a value or price serves as the numerator and financial, operating, or physical data serve as the denominator.

3.28 *Value in Use*. This value type focuses on the value that specific property contributes to the enterprise/entity of which it is a part without regard to the property's *highest and best use* or the monetary amount that might be realised upon its sale. Value in use is the value a specific property has for a specific use to a specific user and is, therefore, non-market related.

4.0 Relationship to Accounting Standards

4.1 Intangible asset valuations are commonly used as a basis for making allocations of value for various assets to aid in the establishment or restatement of financial statements. In this context, Intangible Asset Valuers reflect the *Market Value* of all components of a business's balance sheet in order to meet accounting Standards, having regard to the convention that reflects the effect of changing prices.

4.2 Other considerations relative to the relationship of intangible asset valuations and accounting Standards are similar to the provisions discussed in International Valuation Application 1 (IVA 1).

4.3 International Accounting Standard 38 (IAS 38) prescribes the accounting treatment for intangible assets, discusses the criteria an intangible asset must meet for recognition, specifies the carrying amount of intangible assets, and sets forth requirements for disclosures about intangible assets.

5.0 Guidance

5.1 **Valuations of intangible assets may be required for a number of possible uses including acquisitions and dispositions of businesses or parts of businesses, mergers, sale of an intangible asset, and the like.**

5.1.1 **Where the purpose of the valuation requires a *Market Value* estimate, the Valuer shall apply definitions, processes, and methodologies consistent with their provision in IVS 1.**

5.1.2 **When an engagement calls for a value basis other than *Market Value,* the Valuer shall clearly identify the type of value involved, define such value, and take steps neces-**

sary to distinguish the value estimate from a *Market Value* estimate.

5.2 If, in the opinion of the Valuer, certain aspects of an engagement indicate that a departure from any provision of the International Valuation Standards or of this GN is necessary and appropriate, such departure should be considered for disclosure along with the reason for invoking the departure.

5.3 **The Valuer shall take steps to assure that all data sources relied on are reliable and appropriate to the valuation undertaking.** In many instances it will be beyond the scope of the Valuer's services to perform a complete verification of secondary or tertiary data sources. Accordingly, the Valuer shall verify the accuracy and reasonableness of data sources as are customary in the markets and locale of the valuation.

5.4 **Valuers of intangible assets must frequently rely on information received from a client or from a client's representatives. The source of any such data relied upon must be cited by the Valuer in oral or written reports, and the data shall be reasonably verified wherever possible. The requirements for Valuation Reports are addressed in the IVS Code of Conduct, and IVS 3, Valuation Reporting.**

5.5 Although many of the principles, methods, and techniques of intangible asset valuation are similar to those used in other fields of valuation, valuations of intangible assets require special education, training, skills, and experience.

5.6 **A description of the valuation assignment must include**

5.6.1 **identification of the intangible asset(s), or the ownership interest in the intangible asset(s), to be valued;**

5.6.2 **the effective date of the valuation;**

5.6.3 **the definition of value;**

5.6.4 **the owner of the interest; and**

5.6.5 **the purpose and use of the valuation.**

5.7 **Factors to be considered by the Intangible Asset Valuer include:**

5.7.1 **The rights, privileges, or conditions that attach to the ownership interest**

5.7.1.1 Ownership rights are set forth in various legal documents. In various States, or in some legal jurisdictions, these documents may be called patents, trademarks, brands, know-how, databases, and copyrights, to name a few.

5.7.1.2 Whoever owns the interest is bound by the documents that record such interest in the intangible assets. There may be rights and conditions contained in an agreement or exchange of correspondence, and these rights may or may not be transferable to a new owner of the interest.

5.7.2 **Remaining economic life and/or legal life of the intangible asset**

5.7.3 **The earnings capacity of the intangible assets**

5.7.4 **The nature and history of the intangible assets.** Since value resides in the benefits of future ownership, history is valuable in that it may give a guide to the expectations of the intangible assets for the future.

5.7.5 **The economic outlook that may affect the subject intangible assets,** including political outlook and government policy. Matters such as the exchange rate and inflation and interest rates may affect intangible assets that operate in different sectors of the economy quite differently.

5.7.6 **The condition and outlook of the specific industry,** which may affect the subject intangible assets

5.7.7 **Intangible value may also be contained in undifferentiated assets, often called *goodwill*.** Note that goodwill value in this context is similar to goodwill in the accounting sense in that both are the residual value (historical cost in accounting terms) after all other assets have been taken into account.

5.7.8 **Prior transactions in ownership interests of the subject intangible assets**

5.7.9 **Other market data,** e.g., rates of return on alternative investments, etc.

5.7.10 **The market prices for acquisition of similar intangible assets interests or intangible assets**

5.7.10.1 Often, particularly in the use of acquisition transactions, adequate information is difficult or impossible to obtain. While the actual transaction price may be known, the Valuer may not know what warranties and indemnities were given by the seller, what terms were given or received, or what impact taxation planning had on the transaction.

5.7.10.2 Comparable data should always be used with care, and numerous adjustments may need to be made.

5.7.11 **Adjustment of historical financial statements to estimate the economic abilities of and prospects for the intangible assets**

5.7.12 **Any other information the Valuer believes to be relevant**

5.8 **Intangible asset valuation approaches**

5.8.1 ***Cost approach,*** often called the cost to recreate, the cost approach is also known as the *adjusted asset approach*.

5.8.1.1 A cost-based approach is founded on the Principle of Substitution, i.e., an asset is worth no more than it would cost to replace all of its constituent parts.

5.8.1.2 In the execution of the cost approach, **the cost of each item in the creation of the assets, including developer's profit, must be estimated using the knowledge possessed as of the valuation date.**

5.8.2 ***Income capitalisation approach* to intangible asset valuation**

5.8.2.1 **The *income approach* estimates the value of an intangible asset or of intangible asset ownership interests by calculating the present value of anticipated benefits. The two most common *income approach* methods are *(direct) capitalisation* of income and *discounted cash flow analysis* (DCF).**

5.8.2.1.1 **In *(direct) capitalisation* of income, a representative income level is divided by a capitalisation rate or multiplied by an income multiple (capitalisation factor) to convert the income into value.**

5.8.2.1.2 Income is typically allocated to the various intangible assets by the Valuer. Care must be taken so that the income allocated to all of the individual assets does not exceed the income available to all assets.

5.8.2.1.3 In theory, income can consist of a variety of types of income and cash flow. In practice, the income measure is usually pre-tax income or post-tax income. If the capitalisation methods are used, the economic life of the assets must be infinite, or very long.

5.8.2.1.4 **In DCF *analysis* and/or *dividend method,* cash receipts are estimated for each of several future periods. These receipts are converted to value by the application of a discount rate, using present value techniques.** Many definitions of *cash flow* could be used. Discounting methods are most commonly used for intangible assets with finite economic lives. **The time period covered by the discounting methods is normally the shorter of the economic life or the legal life (the definable period over**

which the asset or interest therein is legally protected).

5.8.2.1.4.1 **Economic life** is measured as the period when the intangible assets can be expected to give the owner an economic return on the assets. An example is computer software that may have an expected life of 36 months before it is necessary to replace it with an updated version.

5.8.2.1.4.2 **Legal life** is measured as the period when the intangible asset can be protected by law. An example is a patent that has a definable life at its inception and that slowly, over time, goes to zero.

5.8.2.1.5 **Capitalisation rates and discount rates are derived from the market and are expressed as price multiples (derived from data on publicly traded businesses or transactions) or an interest rate (derived from data on alternative investments).**

5.8.2.2 **Anticipated income or benefits are converted to value using calculations that consider the expected growth and timing of the benefits, the risk associated with the benefit stream, and the time value of money.**

5.8.3 ***Market (sales comparison) approach* to intangible asset valuation**

5.8.3.1 **The *market approach* compares the subject to similar intangible assets or intangible asset ownership interests and securities that have been sold in the open market.**

5.8.3.2 **The two most common sources of data used in the *market approach* are markets in which ownership interests of similar intangible assets are traded and prior transactions in the ownership of the subject intangible assets.**

5.8.3.2.1 **There must be a reasonable basis for comparison with and reliance upon the similar intangible assets in the market approach.** These similar intangible assets should be in the same industry as the subject or in an industry that responds to the same economic variables. The comparison must be made in a meaningful manner and must not be misleading.

5.8.3.3 Through analysis of acquisitions of intangible assets, the Valuer often computes valuation ratios, which are usually price divided by some measure of income or net assets. Care must be used in calculating and selecting these ratios.

5.8.3.3.1 The ratio(s) selected must provide meaningful information about the value of the intangible assets.

5.8.3.3.2 The data on the similar intangible assets used to compute the ratio must be accurate.

5.8.3.3.3 The calculation of ratios must be accurate.

5.8.3.3.4 If the data are averaged, the time period considered and the averaging method must be appropriate.

5.8.3.3.5 All calculations must be done in the same way for both the similar intangible assets and the subject intangible assets.

5.8.3.3.6 The price data used in the ratio(s) must be valid as of the valuation date and representative of the market at that time.

5.8.3.3.7 Where appropriate, adjustments may need to be made to render the similar intangible assets and the subject intangible assets more comparable.

5.8.3.3.8 Adjustments may need to be made for unusual, non-recurring, and non-operating items.

5.8.3.3.9 The selected ratios must be appropriate given the differences in risk and expectations of the similar intangible assets and the subject intangible assets.

5.8.3.3.10 Several value indications may be calculated since several valuation multiples may be selected and applied to the subject intangible assets.

5.8.3.4 **When prior transactions in the subject intangible assets are used to provide valuation guidance, adjustments may need to be made for the passage of time and for changed circumstances in the economy, the industry, and the intangible assets.**

5.9 **Reconciliation processes**

5.9.1 **The value conclusion shall be based upon**

5.9.1.1 **the definition of value, and**

5.9.1.2 **all relevant information as of the valuation date necessary in view of the scope of the assignment.**

5.9.2 **The value conclusion shall also be based on value indications from the valuation methods performed.**

5.9.2.1 The selection of and reliance on the appropriate approaches, methods, and procedures depend on the judgement of the Valuer.

5.9.2.2 The Valuer must use judgement when determining the relative weight to be given to each of the value indications derived during application of the Valuation Process. The Valuer should provide the rationale and justification for the valuation methods used and for the weighting of the methods relied on in reaching the reconciled value conclusion.

6.0 Effective Date

6.1 This International Valuation Guidance Note became effective 1 July 2000.