

# IVS 210 INTANGIBLE ASSETS



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**A A B E**

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# Business & Intangible Assets Valuation



The logo for the International Valuation Standards Council (IVSC) is located in the top left corner. It consists of the letters 'IVSC' in a white, sans-serif font, with a small purple checkmark symbol integrated into the letter 'V'. The text is set against a dark purple, tilted rectangular background.

# IVS 210: Intangible Assets

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## Application

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An intangible *asset* is a non-monetary *asset* that manifests itself by its economic properties. It does not have physical substance but grants rights and/or economic benefits to its owner.

Specific intangible assets are defined and described by characteristics such as their ownership, function, market position and image. These characteristics differentiate intangible assets from one another.



## Types of Intangibles

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General Categories of Intangibles:

Marketing-related: Examples include trademarks, trade names, unique trade design and internet domain names.

Customer-related: Examples customer lists, backlog, customer contracts, and contractual and non-contractual customer relationships.

Artistic-related: Examples plays, books, films and music, and from non-contractual copyright protection.

Contract-related: Contract-related intangible assets represent the *value* of rights that arise from contractual agreements. Examples include licensing and royalty agreements, service or supply contracts, lease agreements, permits, broadcast rights, servicing contracts, employment contracts and non-competition agreements and natural resource rights.

Technology-based: Technology-related intangible assets arise from contractual or non-contractual rights to use patented technology, unpatented technology, databases, formulae, designs, software, processes or recipes.



## What am I valuing?

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Particularly in valuing an intangible *asset*, *valuers must* understand specifically what needs to be valued and the *purpose* of the *valuation*.

For example, customer data (names, addresses, etc) typically has a very different value from customer contracts (those contracts in place on the valuation date) and customer relationships (the *value* of the ongoing customer relationship including existing and future contracts).

Brand value from distribution network value.

What intangible assets need to be valued and how those intangible assets are defined *may* differ depending on the *purpose* of the *valuation*, and the differences in how intangible assets are defined can lead to *significant* differences in *value*.



## What am I valuing?

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*Valuers may perform direct valuations of intangible assets where the value of the intangible assets is the purpose of the analysis or one part of the analysis.*

However, when *valuing* businesses, business interests, real property, and machinery and equipment, *valuers should* consider whether there are intangible assets associated with those *assets* and whether those directly or indirectly impact the *asset* being valued.

For example, when *valuing* a hotel based on an income approach, the contribution to *value* of the hotel's brand *may* already be reflected in the profit generated by the hotel.





## Market Approach

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Where evidence of either *prices* or valuation multiples is available, *valuers should* make adjustments to these to reflect differences between the subject *asset* and those involved in the transactions.

These adjustments are necessary to reflect the differentiating characteristics of the subject intangible *asset* and the *assets* involved in the transactions. Such adjustments *may* only be determinable at a qualitative, rather than quantitative, level.

However, the need for *significant* qualitative adjustments *may* indicate that another approach would be more appropriate for the *valuation*.



## Income Approach

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Under the income approach, the *value* of an intangible *asset* is determined by reference to the present value of income, cash flows or cost savings attributable to the intangible *asset* over its economic life.

Income related to intangible assets is frequently included in the price paid for goods or a service. It *may* be challenging to separate the income related to the intangible *asset* from income related to other tangible and intangible assets. Many of the income approach methods are designed to separate the economic benefits associated with a subject intangible *asset*.

The most common method applied to the *valuation* of intangible assets and is frequently used to value intangible assets including the following:

- (a) technology,
- (b) customer-related intangibles (eg, backlog, contracts, relationships),
- (c) tradenames/trademarks/brands,
- (d) operating licenses (eg, franchise agreements, gaming licenses, broadcast spectrum), and
- (e) non-competition agreements.



## Income Approach - Methods

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There are many income approach methods. The more common ones are :

- (a) excess earnings method,
- (b) relief-from-royalty method,
- (c) premium profit method or with-and-without method,
- (d) greenfield method, and
- (e) distributor method.



## Income Approach – Excess Earnings

The excess earnings method estimates 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* required to generate the cash flows (“contributory *assets*”).

It is often used for *valuations* where there is a requirement for the acquirer to allocate the overall price paid for a business between tangible *assets*, identifiable intangible assets and goodwill.

Contributory *assets* are *assets* that are used in conjunction with the subject intangible *asset* in the realisation of prospective cash flows associated with the subject intangible *asset*. *Assets* that do not contribute to the prospective cash flows associated with the subject intangible *asset* are not contributory *assets*.

The excess earnings method can be applied using several periods of forecasted cash flows (“multi-period excess earnings method” or “MPEEM”), a single period of forecasted cash flows (“single-period excess earnings method”) or by capitalising a single period of forecasted cash flows (“capitalised excess earnings method” or the “formula method”).



## Income Approach – Excess Earnings

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The capitalised excess earnings method or formula method is generally only appropriate if the intangible *asset* is operating in a steady state with stable growth/decay rates, constant profit margins and consistent contributory *asset* levels/charges.

As most intangible assets have economic lives exceeding one period, frequently follow non-linear growth/decay patterns and *may* require different levels of contributory *assets* over time, the MPEEM is the most commonly used excess earnings method as it offers the most flexibility and allows *valuers* to explicitly forecast changes in such inputs.



## Income Approach – Excess Earnings

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Whether applied in a single-period, multi-period or capitalised manner, some key elements to be considered:

c) adjust the expenses to exclude those related to creation of new intangible assets that are not required to generate the forecasted revenue and expenses. Profit margins in the excess earnings method *may* be higher than profit margins for the overall business because the excess earnings method excludes investment in certain new intangible *assets*. For example:

1. research and development expenditures related to development of new technology would not be required when *valuing* only existing technology, and
2. marketing expenses related to obtaining new customers would not be required when valuing existing customer-related intangible assets.

(d) identify the contributory *assets* that are needed to achieve the forecasted revenue and expenses. Contributory *assets* often include working capital, fixed *assets*, assembled workforce and identified intangible *assets* other than the subject intangible *asset*,

(e) determine the appropriate rate of return on each contributory *asset* based on an assessment of the risk associated with that *asset*. For example, low-risk *assets* like working capital will typically have a relatively lower required return. Contributory intangible assets and highly specialised machinery and equipment often require relatively higher rates of return,



## Income Approach – Excess Earnings

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Contributory asset charges (CACs) *should* be made for all the current and future tangible, intangible and financial assets that contribute to the generation of the cash flow, and if an asset for which a CAC is required is involved in more than one line of business, its CAC *should* be allocated to the different lines of business involved.

CACs are generally computed on an after-tax basis as a fair return on the *value* of the contributory asset, and in some cases a return of the contributory asset is also deducted. The appropriate return on a contributory asset is the investment return a typical *participant* would require on the asset. The return of a contributory asset is a recovery of the initial investment in the asset. There *should* be no difference in *value* regardless of whether CACs are computed on a pre-tax or after-tax basis.



## Income Approach – Excess Earnings

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The excess earnings method *should* be applied only to a single intangible *asset* for any given stream of revenue and income (generally the primary or most important intangible *asset*).

For example, in valuing the intangible assets of a company utilising both technology and a tradename in delivering a product or service (ie, the revenue associated with the technology and the tradename is the same), the excess earnings method *should* only be used to value one of the intangible assets and an alternative method *should* be used for the other *asset*.

However, if the company had multiple product lines, each using a different technology and each generating distinct revenue and profit, the excess earnings method *may* be applied in the *valuation* of the multiple different technologies.





## Income Approach – Relief from Royalty

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Under the relief-from-royalty method, the *value* of an intangible *asset* is determined by reference to the *value* of the hypothetical royalty payments that would be saved through owning the *asset*, as compared with licensing the intangible *asset* from a third party.

Conceptually, the method *may* also be viewed as a discounted cash flow method applied to the cash flow that the owner of the intangible *asset* could receive through licensing the intangible *asset* to third parties.



## Income Approach – Relief from Royalty – Key Steps

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The key steps are:

- (a) develop projections associated with the intangible *asset* being valued for the life of the subject intangible asset. The most common metric projected is revenue, as most royalties are paid as a percentage of revenue. However, other metrics such as a per-unit royalty *may* be appropriate in certain *valuations*,
- (b) develop a royalty rate for the subject intangible asset. Two methods can be used to derive a hypothetical royalty rate. The first is based on market royalty rates for comparable or similar transactions. A prerequisite for this method is the existence of comparable intangible assets that are licensed at arm's length on a regular basis. The second method is based on a split of profits 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,



## Income Approach – Relief from Royalty – Key Steps

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(d) estimate any additional expenses for which a licensee of the subject *asset* would be responsible. This can include upfront payments required by some licensors.

A royalty rate *should* be analysed to determine whether it assumes expenses (such as maintenance, marketing and advertising) are the responsibility of the licensor or the licensee.

A royalty rate that is “gross” would consider all responsibilities and expenses associated with ownership of a licensed *asset* to reside with the licensor,

A royalty that is “net” would consider some or all responsibilities and expenses associated with the licensed *asset* to reside with the licensee.

Depending on whether the royalty is “gross” or “net”, the *valuation should* exclude or include, respectively, a deduction for expenses such as maintenance, marketing or advertising expenses related to the hypothetically licensed asset,



## Income Approach – Relief from Royalty – Key Steps

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When selecting a royalty rate, a *valuer should* also consider the following:

- (a) When entering a licence arrangement, the royalty rate *participants* would be willing to pay depends on their profit levels and the relative contribution of the licensed intangible asset to that profit. For example, a manufacturer of consumer products would not license a tradename at a royalty rate that leads to the manufacturer realising a lower profit selling branded products compared with selling generic products.
- (b) When considering observed royalty transactions, a *valuer should* understand the specific rights transferred to the licensee and any limitations. For example, royalty agreements *may* include *significant* restrictions on the use of a licensed intangible asset such as a restriction to a particular geographic area or for a product. In addition, the *valuer should* understand how the payments under the licensing agreement are structured, including whether there are upfront payments, milestone payments, puts/calls to acquire the licensed property outright, etc.



## Income Approach – With and Without

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The with-and-without method indicates the *value* of an intangible asset by comparing two scenarios: one in which the business uses the subject intangible asset and one in which the business does not use the subject intangible asset (but all other factors are kept constant).

The comparison of the two scenarios can be done in two ways:

- (a) calculating the *value* of the business under each scenario with the difference in the business values being the *value* of the subject intangible asset, and
- (b) calculating, for each future period, the difference between the profits in the two scenarios. The present value of those amounts is then used to reach the *value* of the subject intangible asset.

The with-and-without method is frequently used in the *valuation* of non-competition agreements but *may* be appropriate in the *valuation* of other intangible assets in certain circumstances.



## Income Approach – Greenfield Method

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Under the greenfield method, the *value* of the subject intangible is determined using cash flow projections that assume the only *asset* of the business at the valuation date is the subject intangible. All other tangible and intangible assets *must* be bought, built or rented.

The greenfield method is conceptually similar to the excess earnings method. However, instead of subtracting contributory *asset* charges from the cash flow to reflect the contribution of contributory *assets*, the greenfield method assumes that the owner of the subject *asset* would have to build, buy or rent the contributory *assets*. When building or buying the contributory *assets*, the *cost* of a replacement *asset* of equivalent utility is used rather than a reproduction cost.

The greenfield method is often used to estimate the *value* of "enabling" intangible assets such as franchise agreements and broadcast spectrum



## Income Approach – Distributor Method

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The distributor method, sometimes referred to as the disaggregated method, is a variation of the multi-period excess earnings method sometimes used to value customer-related intangible assets.

The underlying theory of the distributor method is that businesses that are comprised of various functions are expected to generate profits associated with each function.

As distributors generally only perform functions related to distribution of products to customers rather than development of intellectual property or manufacturing, information on profit margins earned by distributors is used to estimate the excess earnings attributable to customer-related intangible assets.

The distributor method is appropriate to value customer-related intangible assets when another intangible *asset* (for example, technology or a brand) is deemed to be the primary or most *significant* intangible *asset* and is valued under a multi-period excess earnings method.



## Income Approach – Distributor Method – Key steps

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- (a) prepare projections of revenue associated with existing customer relationships. This *should* reflect expected growth in revenue from existing customers as well as the effects of customer attrition,
- (b) identify comparable distributors that have customer relationships similar to the subject business and calculate the profit margins achieved by those distributors,
- (c) apply the distributor profit margin to the projected revenue,





## Income Approach – Distributor Method – Key steps

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(d) identify the contributory *assets* related to performing a distribution function that are needed to achieve the forecast revenue and expenses.

Generally distributor contributory *assets* include working capital, fixed *assets* and workforce as distributors seldom require other *assets* such as trademarks or technology. The level of required contributory *assets should* also be consistent with *participants* performing only a distribution function,

(e) determine the appropriate rate of return on each contributory *asset* based on an assessment of the risk associated with that *asset*,

(f) in each forecast period, deduct the required returns on contributory *assets* from the forecast distributor profit to arrive at the excess earnings attributable to only the subject intangible *asset*,



## Cost Approach

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Under the cost approach, the *value* of an intangible *asset* is determined based on the replacement cost of a similar *asset* or an *asset* providing similar service potential or utility.

The cost approach is commonly used for intangible assets such as the following:

- (a) acquired third-party software,
- (b) internally-developed and internally-used, non-marketable software, and
- (c) assembled workforce.



## IVS 105

The cost approach *may* be used when no other approach is able to be applied; however, a *valuer should* attempt to identify an alternative method before applying the cost approach in situations where the subject *asset* does not meet the criteria in paras 60.2 and 60.3 of IVS 105 *Valuation Approaches and Methods*.

The cost approach *should* be applied and afforded *significant weight* under the following circumstances:

- (a) *participants* would be able to recreate an *asset* with substantially the same utility as the subject *asset*, without regulatory or legal restrictions, and the *asset* could be recreated quickly enough that a *participant* would not be willing to pay a *significant* premium for the ability to use the subject *asset* immediately,
- (b) the *asset* is not directly income-generating and the unique nature of the *asset* makes using an income approach or market approach unfeasible, and/or
- (c) the *basis of value* being used is fundamentally based on replacement cost, such as replacement value.



## IVS 105

Although the circumstances in para 60.2 would indicate that the cost approach *should* be applied and afforded *significant weight*, the following are additional circumstances where the cost approach *may* be applied and afforded *significant weight*. When using the cost approach under the following circumstances, a *valuer should* consider whether any other approaches can be applied and *weighted* to corroborate the value indication from the cost approach:

- (a) *participants* might consider recreating an *asset* of similar utility, but there are potential legal or regulatory hurdles or *significant* time involved in recreating the *asset*,
- (b) when the cost approach is being used as a reasonableness check to other approaches (for example, using the cost approach to confirm whether a business valued as a going-concern might be more valuable on a liquidation basis), and/or
- (c) the *asset* was recently created, such that there is a high degree of reliability in the assumptions used in the cost approach.