

3 June 2009

Comments on Revised International Valuation Guidance Notes

- **No. 4 “Valuation of Intangible Assets” and**
- **No. 16 “Valuation of Intangible Assets for IFRS Reporting Purposes”**

GN No. 4 „Valuation of Intangible Assets”

A) 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?

No further definitions are required for understanding of the GN when to be read in conjunction with IVS. Definitions should be kept to a minimum.

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 categorization 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 categorization is important, is it important that the categories in GN 4 follow the illustrative examples in IFRS 3?*
- *If it is considered important to follow the categorization in IFRSs, should "Contract Related" assets be separately categorized from the other types?*

Categorization is helpful in the identification process. As GN 4 is not specific to IFRS, the categories do not need to be the same. However, if IFRS is considered important, a separate category for "Contract Related" assets might be useful to reflect fully IFRS 3 categorization.

3. *Various common valuation methods are described in this draft. These are 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?*

The methods listed reflect the major valuation methodologies adopted by valuation professionals in the valuation of intangible assets.

Sometimes used in practice and not listed is the "Direct Cash Flow method". Cash Flows directly attributable to the subject intangible asset are capitalized through use of a suitable discount factor. The approach requires the identification of the cash flows directly achievable through the use of the subject asset.

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 judgment 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.*

The degree of detail (in particular with respect to valuation inputs for PFI) goes beyond that which is necessary for a professional user. The other risk of the level of detail is that it falls short of what would be included in technical or best practice guide (refer to The Appraisal Foundation exposure draft on contributory asset charges).

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?*

As stated in the GN “the method or methods used and the reason why they are considered appropriate should normally be documented in the Valuation Report”. The use of alternative method or methods as a cross check is also appropriate. Requiring multiple methods would not be appropriate. Accordingly the wording of the GN is appropriate although sections 6.6 and 6.7 are not required and should not be included.

B) Other Comments

1. Spelling and wording should be improved.
2. 1.2 - It is stated that “... the objective of the GN is to provide guidance on internationally recognized principles under which valuations of intangible assets are performed ...” It is not clear what is meant by “internationally recognized principles”. It should be clarified that guidance is not restricted to a specific accounting environment as IFRS. References are made to IFRS in the presentation of the categories for intangibles.
3. 3.2 - The paragraph states that Goodwill is a future economic benefit and “Goodwill cannot be secured legally by a business and is not separable from a business”. Following the logic in paragraph 3.1 and IFRS 3, one of the two conditions is sufficient to describe the Goodwill.

A more comprehensive approach for description of goodwill might be helpful for understanding the financial substance of goodwill and its valuation as the sum of specific items (instead of as a residual), e. g. a list of examples for major components of goodwill:

- ability to recreate amortizable intangible assets in the future (such as technologies, customer relationships, ...),
- synergies (such as reduction of operating costs, economies of scale, product mix dynamics, ...),

- growth opportunities (such as in process R&D projects, specific market trends for niche activities, ...),
 - Organizational capital (such as assembled network, assembled workforce ...).
4. 3.6 - The meaning of “contractual and rights” is not clear.
 5. 3.8 - It is stated that “specific intangible assets are defined and identified by characteristics such as their function, market position, global reach, capability and image.” The term “identified” might be confusing for readers as these characteristics are not the IFRS identification criteria explained above. “Described” might be a better term in this context.
 6. 3.8 - 3.9 - The paragraphs are dealing with the characteristics of intangibles. A more structured approach for description might be helpful for understanding, e. g. first a list of examples for major characteristics and in the following paragraphs details on important characteristics like ownership rights.
 7. 3.10 - The general statement of the paragraph is that intangibles within the same class will still have different characteristics. There should be no scope for confusion without this paragraph.
 8. 4.7 - The paragraph is listing examples for situations in which entity specific factors should be reflected in the value of an asset to a specific owner:
 - Testing intangible assets for impairment
 - To support investment decisions
 - Reviewing the performance of assets.

Another example with practical relevance is the liquidation decision. In this case additional assumptions are required regarding the timing of the liquidation and the expected cash flows and costs from the forced sale.

9. 4.15 - The paragraph describes restrictions in reliability of the market transactions method due to little available information on comparable transactions. It should be added that the selection of the transactions and the financial parameters should be carefully explained.
- 10.4.22 - The TAB is introduced. More details on the calculation of the TAB would be useful for professional readers (e. g. iterative calculation of the TAB vs. application of a step up factor).
- 11.4.27 - Valuation inputs for the relief from royalty method are listed. It should be mentioned that the hypothetical royalty rate is usually derived from market based royalty rates for comparable or similar transactions. Prerequisite for this method is the existence of comparable assets that are licensed at arm’s length on a regular basis.

12.4.40 - The paragraph is using the terms "fair return on or of a contributory asset". Prior explanation of the terms "return on asset" and "return of asset" would be beneficial for the understanding of the passage. The explanation is done later in Section 5 "Valuation Inputs".

13.4.42 - The paragraph states that intangibles "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". In practice the method is generally used for intangibles with the biggest impact on the Cash Flows, so that contributory assets are effectively only contributing.

14.4.45 - The meaning of the last sentence is not clear.

GN No. 16 „Valuation of Intangible Assets for IFRS Reporting Purposes“

A) Questions for Respondents

1. *Some respondents to the discussion paper consider that because IAS 38 only permits intangible assets for which there is an active market to be carried at their revalued amount, and that the definition in IAS 38 of an active market includes a requirement that the assets traded are homogenous, or identical, it is necessary to further define the characteristics of assets that are “identical, similar and different”. They argue that because IAS 38 effectively directs that the fair value of qualifying identical assets is based on prices that are available to the public, valuers need guidance for which assets a valuation technique other than a straight forward price x quantity calculation may be used when valuing intangible assets under other IFRSs. The Board’s view is that there is little scope for confusion as the adjectives in question are used in IAS 38 with their normally understood meaning, and any attempt to draw clear lines between classes of intangible assets based on prescriptive definitions is not only unnecessary but also a source of potential anomalies.*

Do respondents consider that further explanation of the characteristics of identical, similar and different intangible assets is required?

Further explanation is not required as there is little scope for confusion and the valuation work should be based on the IFRS definitions.

2. *IAS 38 contains a precise definition of an “active market”, which describes not only the characteristics of the market but also the nature of the assets traded, i.e. they must be homogenous. This has led some commentators to the view that markets that either do not meet the criteria in IAS 38 or involve heterogeneous assets should logically be termed “inactive markets”. Others consider that this is misleading, as activity in markets is not dependant upon whether the goods being traded are similar, but upon supply and demand and the extent to which either is elastic. They point to the fact that there are many active markets involving assets that are not homogeneous. IVS does not have a single definition of a market, although in discussion under “Concepts Fundamental to Generally Accepted Valuation Principles” (p21 IVS 2007) it is described simply as an environment in which goods and services are exchanged through a price mechanism. Although market concepts are discussed throughout IVS, no need has previously been identified to categorize and define different types of market. Do respondents consider that in order to improve consistency of intangible asset valuations prepared for use under IFRSs it is necessary for IVS to explore and define what is meant by a “market” and by sub descriptions such as “active”, “inactive”, “accessible”, etc?*

Section 2 contains the definition of an “active market” according to IFRS 3. The IVS should not explore and define what is meant by a “market” and by sub descriptions such

as “active”, “inactive”, “accessible” etc. as this could lead to conflicts and confusion with the IFRS definitions. In addition, the current debates on the use of fair value for accounting and the impacts on the financial markets of “mark to market” accounting for financial instruments in inactive markets may lead to some changes.

3. *This draft is intended to provide valuers with a briefing of the valuation objectives under various IFRSs. It is not intended to be a guide to the accounting requirements. Consequently, only selected extracts from relevant IFRSs documents have been referred to, and elsewhere the IFRSs requirements have been paraphrased or précised. Do respondents consider that this guidance contains sufficient references to IFRSs to enable a valuer to understand the valuation objectives and criteria necessary to produce valuations that are suitable for use by a reporting entity in preparing its financial statements, or is more background material on IFRSs required?*

References to IFRS are sufficient for understanding of valuation objectives and basic criteria. Valuers should make direct reference to the IFRS. The GN should be restricted to matters that need to be emphasized, areas where the terms used by IFRS conflict or could be confused by IVS terms or definitions or where further guidance is needed.

An area where further guidance would be useful is with respect to the determination of pre tax discount rates and the interaction with accounting for income taxes as set out in the basis for conclusions to IAS 36 at BCZ81 to BC94.

B) Other Comments

1. 1.3 - The paragraph states that the GN addresses each IFRS under which valuations of intangibles are required and states that the following is considered for each of these IFRS:

- The appropriate bases of valuation
- Appropriate valuation methods
- Specific issues arising and
- Cross-checks that are specifically relevant.

Contrary to the other points, cross-checks are not directly related to the IFRS, but part of the valuation exercise in a business combination. As a consequence, this section could be reclassified into GN4 section 6.

Also, the importance of identification and recognition requirements of intangibles based on the IFRS criteria should be adequately reflected as they might differ from the IVS guidance.

The following points are proposed as considerations for each of the IFRS:

- Identification and recognition
 - The appropriate bases of valuation
 - Appropriate valuation methods and
 - Specific issues arising.
2. Section 2 "IFRSs Definitions" - "Carrying amount" should be explained as the term is used in the subsequent sections. ("Carrying amount is the amount at which an asset is recognized after deducting any accumulated depreciation (amortization) and accumulated impairment losses thereon."; IAS 36.06)
 3. Section 2 "IFRSs Definitions" - Definitions are exclusively from IAS 38 and IAS 36. This could be confusing. It should be mentioned that those definitions are consistent with those presented and to be used under IFRS 3 and IFRS 5.
 4. Section 3 "Valuation requirements specific to IFRSs" describes the differences between the terms used in IFRS and IVS as stated in paragraph 3.1. Specific valuation requirements are not described in this section. Heading should be adjusted accordingly or content should be amended.
 5. 3.4 - The revaluation model is introduced but not explained. An explanation would be beneficial for the understanding of the passage (IAS 38.75). Similar, the cost model is mentioned but not explained in 7.1.
 6. 4.3 - Wording and spelling should be improved. Reference is IAS 38.35 and should be mentioned as this is done also in the previous paragraph.
 7. 4.3 - 4.4 - More detailed description of requirements of IFRS 3 (2008) on recognition and measurement would be beneficial for guidance:
 - Categories and identification criteria for intangibles should be described; e.g. reliable measurement is no criterion acc. to IFRS 3 (2008).
 - Assembled workforce and other intangibles that are not identifiable should be explained [IFRS 3 (2008).B37 - B.40].
 - Exceptions in recognition and measurement should be described (Goodwill, reacquired rights, assets held for sale etc.) [IFRS 3 (2008).21].
 - Description of measurement principles for identifiable assets would be important (no separate valuation allowances, intent of acquirer not relevant etc.) [IFRS 3 (2008).B41 - B.45].
 8. 4.5 - 4.8 - Listing of respective IFRS sources would be beneficial for application of GN. Accounting for negative goodwill should be explained briefly as this is of relevance in practice.

9. 4.17 - It is explained that the valuation of the acquired business as a whole requires the forecasting of cash flows. Although in practice the income approach is used, for consistency with GN 4 it could be noted that this is theoretically only one possible valuation approach for a business. Reference to GN 4 could be made here.

10.5.1 - 5.3 - Wording should be improved.

11.5.9 - 5.10 - Additional information should be provided on the allocation of Goodwill to CGUs and on Testing CGUs with Goodwill for Impairment as this might be a complex issue in practice (IAS 36.80 - IAS 36.99).