Valuation of Intangibles

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PRICEWATERHOUSECOOPERS

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Significance of Intangibles

Significance of Intangibles

- Knowledge, learning and innovation are sources of competitive advantage and power modern economies
- The phrase knowledge-based economy refers to the use of *knowledge* to produce *economic* benefits
- Intangible assets are not new. Adam Smith had recognised importance of 'skill, dexterity and judgment'
- Physical resources are finite and are commodities. Scarcity mitigated by knowledge substitution and is the driver for investments in research and development
- Every good has knowledge content. Physical inputs are being replaced by knowledge based inputs thus reducing the dimensions of products, improving quality and durability

Significance of Intangibles

- Emphasis on intellectual property as the source of value has increased considerably in recent past
- Intangibles/ knowledge assets particularly significant in industries such as pharmaceuticals, software, aviation. Lately even financial institutions in the USA reported to be registering patents
- Large part of market capitalisation attributable to intangibles as is evident from Price/Book ratios

Significance of Intangibles

Company	Sector	Equity mkt.cap a	Debt b	Ent. Value a+b=c	Assets (per books) d	Intangibles c-d=e	% e/c=f
India						**in inr billion**	
Infosys	IT	1,146.8	-	1,146.8	112.6	**1,034.2**	**90%**
Dabur	FMCG	87.0	1.6	88.6	6.4	**82.2**	**93%**
HUL(HLL)	FMCG	433.6	0.9	434.5	27.2	**407.3**	**94%**
Glaxo	Pharma	98.1	0.1	98.1	12.1	**86.0**	**88%**
Ranbaxy	Pharma	140.5	39.6	180.1	55.3	**124.8**	**69%**
USA						**in usd billion**	
Google	Internet	158.3	-	158.3	19.7	**138.5**	**88%**
Microsoft	Softwar	281.2	39.6	320.8	31.1	**289.7**	**90%**
Cocacola	Bev	122.4	9.7	132.1	28.7	**103.5**	**78%**
E.ON AG	Utility	105.7	18.4	124.1	87.6	**36.6**	**29%**
GSK	Health	142.9	2.1	145.0	22.5	**122.5**	**85%**

Data above based on public sources purely for representational purposes and is subject to change

Largely **Goodwill, Patents, Brands, networks, Copyrights, Human resource etc.**

Nature
and
Types of Intangibles

Nature of Intangibles

- Intangible assets do not have a physical form/ financial embodiment but are expected to provide <u>future benefits</u> which eg. human capital, technology

- *"intangible assets are all the elements of a business enterprise that exist in addition to working capital and tangible assets. They are the elements, after working capital and tangible assets, that make the business work and are often the primary contributors to the <u>earning power</u> of the enterprise. Their existence is dependent on the presence, <u>or the expectation, of earnings</u>"* - Valuation of Intellectual Property and Intangible Assets by Gordon V Smith and Russell L Parr, 1994, page 83

Nature of Intangibles

- Physical property because of its material existence are 'excludable' and 'rivalrous'; can be consumed by one person at a given point in time
- Intellectual Property Rights (IPR)/ Intangible assets are *non-rivalrous* and may be consumed/ used by many persons at the same time at very little cost/ low cost
- <u>*Sunk cost*</u> incurred on development typically very high. <u>*Reproduction Cost/ marginal cost*</u> of intangible/ IPR is negligible/ marginal
- Most intangibles/ information goods subject to *externalities*- both positive and negative

Nature of Intangibles

- Value of the 'good' to an individual is greater when a large number of people use the good.
- Network externalities cause *positive feedback*, in which initial success is self-reinforcing
- Intangible assets prone to infringements through counterfeiting, duplication, fakes, copying, piracy etc
- Recognition and enforceability of property rights is the cornerstone of a well functioning market economy particularly for intangibles on account of its economic characteristics
- Legal framework/ policy targets *incentivising innovation by ensuring fair return to owner/ developer* counter balanced *by larger interests of the society*

Nature of Intangibles

- Not coincidentally, developed nations account for a large base of IPR have a very strong property rights regime
- Value is linked to exploitation of IPR and is dependent on the associated legal rights
- Unlike physical assets, intangibles not subject to wear and tear; useful economic life is dependent on combination of complex factors

Types of Intangibles…..
(other than Goodwill)

Marketing related	trademarks, service marks, non- compete agreements
Customer related	customer contracts, customer lists, non contractual customer relationships.
Artistic related	musical works, literary works, motion pictures
Technology based	patents, copy rights, trade secrets
Contract based	Lease agreements, franchise agreements, service or supply contracts

Life of Intangibles

Legal life/protection	patent, copyright, trademark, government concession
Events	brand name susceptible to bad publicity, product recall, cultural factors, generic
Obsolescence	technological, functional, not in fashion
Interplay between intangibles	corporate identity without promoter/management

Accounting Issues

Accounting Issues

- Financial reporting is based on technical rules and principles such as the accrual principle, the historical cost principle, focus on transactions etc. Tradition of *conservatism/ prudence*

- Recognizable as assets if there is a supporting transaction with a cost that can be recorded to represent the asset and the cost can directly linked to future benefits

- Non recognition of self generated assets (usually intangibles) may be considered a limitation of current accounting conventions

Accounting Issues

- Assets defined as the "*probable* future economic benefits *controlled* by the firm that can be *reliably* measured"
- Recording of acquired intangibles, is relatively simple, at arms length cost
- Difficulties in measurement and recognition of self generated intangibles *inter alia* include:
  - cost difficult to link to the asset eg. Research vs Development
  - difficulties in estimating probability of success *ex-ante*
  - market for intangibles does not exist to establish arms length price benchmarks
  - control is fuzzy eg workforce

Accounting Issues

- Values of Intangibles surface in events such as mergers, acquisitions. Differences in Generally Accepted Accounting Practices ('GAAP')

- Merger accounting in Indian GAAP as per *Accounting Standard 14 – Accounting for Amalgamation* continues to recognise ***pooling of interests*** method based on historical financials and **purchase** method

- Only mergers under section 391-394 of the Companies Act 1956 recognised under AS 14

- Merger accounting under US GAAP is as per *Statement of Financial Accounting Standard 141 – Business Combinations* under ***purchase method***

Accounting Issues

- ***Purchase method*** provides a more accurate assessment of deal economics wherein the purchase consideration and the fair value of assets/ liabilities surface in the acquirer books
- Criterion for recognition under US GAAP
  - Arising from *contractual/ legal rights*
  - *Separable*
  - *Sold/ transferred/ licensed* with a related contract, asset/ liability

Example

- B Limited is amalgamated into A Limited and the share holders of B Limited receive 100 shares (face value INR 10) of A Limited of fair value of INR 20 each
- Historical statement of assets and liabilities is as under:

		INR
Sources	A Limited	B Limited
Share Capital	1,000	100
Reserves and surplus	1,500	300
Debt	400	400
Total	**2,900**	**800**
Represented by		
Land, building, equipment	2,000	200
Net current assets	900	600
Total	**2,900**	**800**

- Valuable technology, customer contracts developed by B Limited are the key deal drivers for the acquisition

Example

- Purchase consideration/deal economics based on *fair values* and not on *book values*

Consideration	**INR**
Fair value of shares	2,000
Debt	400
Total	**2,400**
Assets	
Land. Building, equipment	250
Net current assets	600
Technology	**1,000**
Customer contracts	**500**
Synergy	**50**
Total	**2,400**

Contd…

Example

- Under Indian GAAP – Pooling of Interests method

			INR
Sources	A Limited	B Limited	Merged
Share Capital	1,000	100	2,000
Reserves and surplus	1,500	300	1,800
Debt	400	400	800
Total	2,900	800	4,600
Represented by			
Fixed Assets	2,000	200	2,200
Net current assets	900	600	1,500
Amalgamation goodwill			900
Total	2,900	800	4,600

Contd…

Example

- Under US GAAP- Purchase method

			INR
Sources	A Limited	B Limited	Merged
Share Capital	1000	100	2,000
Reserves and surplus	1,500	300	2,500
Debt	400	400	800
Total	2,900	800	5,300
Represented by			
Fixed Assets	2,000	200	2,250
Intangibles			1,500
Net current assets	900	600	1,500
Amalgamation goodwill			50
Total	2,900	800	5,300

Accounting Issues

- Intangibles (other than acquired under business combinations) under US GAAP
  - *Statement of Financial Accounting Standard 142 - Goodwill and Other Intangible Assets*

- Intangible assets are to be amortised/ tested for impairment. Concept of indefinitely life intangibles under US GAAP

Accounting Issues

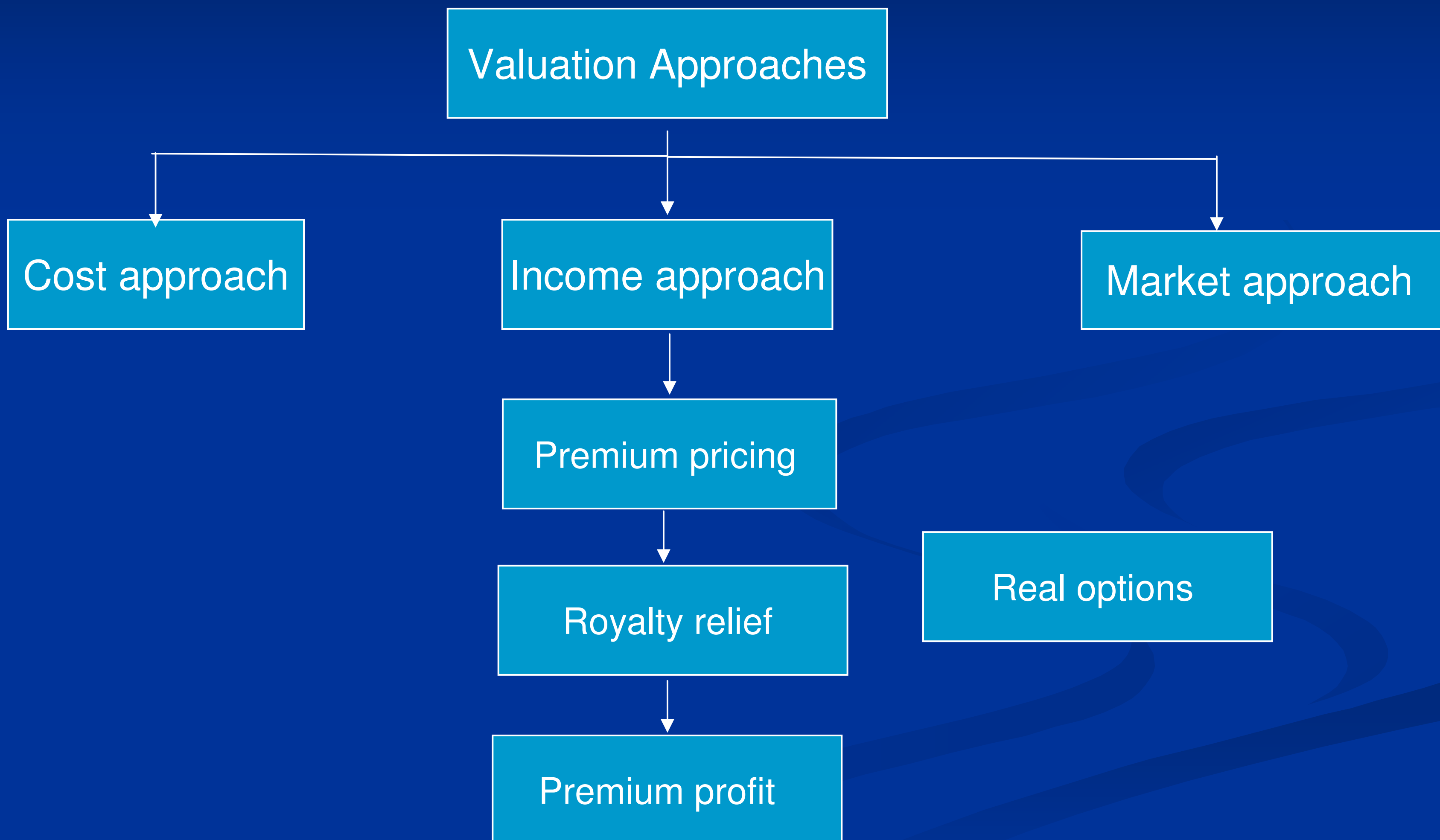
- Under Indian GAAP, Intangibles other than through an 'amalgamation', per *Accounting Standard 26 - Intangible Assets*
- Criterion for recognition
  - probable future economic benefits will flow to the enterprise *and*
  - the cost of the asset can be measured reliably
- Rebuttable presumption of useful life of 10 years
- Impairment test necessary, if the useful life>10 years/ asset not available for use

Valuation Approaches

Valuation

- All expenditure – whether revenue or capital – incurred for generating economic benefits
- Value of an asset is the *net present value* of the cash flows/ income streams attributable to an asset
- Discount rate applied to reflect the risks associated with the cash flows. May be derived from the Weighted Average Cost of Capital ('WACC') of the Enterprise
- *Life of the asset* is a key determinant of value
- Essential to have understanding of *business drivers*. Is it intangibles / physical assets ? Which intangible
- Value usually determined on a 'stand alone' basis

Valuation Approaches



Cost Approach

- *Replacement cost* is cost of reconstructing or replacing a sufficiently comparable asset. *Not considered appropriate for valuing intangibles in most cases.*
  - Intangible are subject to high degree of failures. Probability of success not captured in the 'cost' of subject asset in isolation
  - Value of future income streams diverges significantly from the historical cost

Income Approach

- *Income approach* involves valuation based on expected cash flows/ income streams the subject intangible is expected to generate

- Method employed include:
  - 'Premium profit'
  - 'Premium pricing'
  - 'Relief of Royalty' or 'Royalty Savings'

- Residual earnings after deducting fair returns on all assets employed is an indirect way of deriving the value of intangible assets

Market Approach

- *Market approach* involves comparing the relevant asset parameters with the parameters of a similar asset to derive the value from the transaction price. Parameters could include multiples based on profits, sales, number of units etc
- Prices in a transparent market considered more reliable indicators of value compared to values derived from subjective projections
- Market price= value; if markets are ‘efficient'
- In case of listed entities, possible to derive the value attributed by the market to the intangibles based on market price of shares

Valuation

- Interplay amongst intangibles and tangible assets makes it difficult to isolate income streams associated with specific intangible
- Intangibles considered riskier on account of under mentioned factors
  - not a general use asset; specific to industry
  - exploitation dependent on other supporting infrastructure
  - maintenance expenditure to be incurred on a continuous basis
  - lack of standardisation
  - legal rights?

Valuation

- High degree of illiquidity attached to the assets
- Higher degree of subjectivity in intangibles valuation compared to business valuations

Taxation Aspects

Taxation Aspects

- Availability of tax benefit has a significant impact on valuations. Tax amortisation benefit('TAB') to be considered
- Apart from property law related legislation, investment in education, government can promote development of knowledge assets through fiscal policies.
- Domestic tax law embodied in Income tax Act 1961 ('the Act'), judicial pronouncements, circulars etc.
- Tax benefit can be available either as a revenue expenditure or by way of depreciation in case of assets.

Taxation Aspects

- Depreciation is governed by section 32. Key provisions of the Act are:
  - depreciation available to assessee who owns, either partly or wholly, **and** uses for the purposes of business know-how, patents, copyrights, trademarks, licenses franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after 1April1998
  - rate of depreciation @ 25% on WDV basis
  - Goodwill is *not* depreciable

Taxation Aspects

- Section 35 – Expenditure on scientific research

Nature of expenditure	Quantum of deduction
Any expenditure (including capital expenditure) expended on scientific research related to business (including prior commencement expenses)*	Entire expenditure incurred
Any sum paid to a scientific research organisation with an objective of undertaking scientific research or to an educational institution for social science or statistical research*	One and one- fourth times of the expenditure

* - subject to fulfillment of certain conditions.

Taxation Aspects

- Section 35ABB – Expenditure for obtaining license to operate telecom services
- Section 43(1) – Actual cost

- Asset base for tax depreciation does not change in case of ‘amalgamation’ as defined under section 2(1B) or a ‘demerger’ as per section 2(19AA)

Taxation Aspects

Taxability in relation to transfers:

- **Outright transfer of the asset (IPR) – Taxable as capital gains**
  - Short- term capital gains (< =3 yrs)- Taxable at normal income tax rates
  - Long- term capital gains (> 3 yrs)- Taxable @ 20% plus applicable surcharge and education cess (indexation benefit would be available)

Taxation Aspects

- **Transfer of all or any rights in an IPR – May be taxable as royalty if:**
  - The transfer is not taxable as capital gains; and
  - The payment is covered within the definition of 'royalty' as provided under Section 9(1)(vi) of the Act.

    The above royalty would be taxable under the head 'business income' or 'income from other sources' (as the case may be) in the hands of resident assessees.

Taxation Aspects

- **Taxability of the above royalty in the hands of non resident assessees:**
  - Taxable on gross basis @ 10% plus applicable surcharge and education cess as per Section 115A of the Act (in case the non resident assessee does not have a PE in India, or, the royalty is not effectively connected to the PE of the non resident company in India)
  - Taxable on net basis at normal income tax rates applicable to non-residents (in case the non resident assessee has a PE in India and the royalty is effectively connected to such PE)

Taxation Aspects

- **Section 80QQB of the Act** – Deduction in relation to royalty income of authors of certain books:
  - Subject to fulfillment of certain prescribed conditions, deduction is available in respect of royalty income or copyright fees earned by authors of certain books (other than text books)
  - In the case of an individual resident in India, being an author, whose gross total income includes any income in the nature of lump sum consideration for assignment or grant of any interest in the copyright of any book or royalty or copyright fees for such book, deduction shall be allowed in respect of such income subject to an upper limit of ***INR 0.3 million***

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Taxation Aspects

- If the income is not a lump sum consideration in lieu of all the rights of the assessee in the book, the income before allowing expenses attributable thereto in excess of 15% of the value of such book shall be ignored as not eligible for deduction
    - Income in respect of any book to qualify for deduction under this section should be a work of literary, artistic or scientific nature

Taxation Aspects

- **Section 80RRB of the Act** - Deduction in relation to royalty on patents:
  - Subject to fulfillment of certain prescribed conditions, an individual who is a resident in India and a patentee, shall be eligible for deduction in respect of any income by way of royalty to an upper limit of ***INR 0.3 million.***
  - If a compulsory license is granted in respect of any patent under the Patents Act 1970, the income by way of royalty eligible for deduction under this section shall not exceed the amount under the terms and conditions under the said Act.

Taxation Aspects

Indirect Tax Implications

- **Customs Duties**
  - Drawings and designs exempt from customs duty when imported in paper book form
  - If imported any other form, customs duty leviable at applicable rates

- **Sales Tax / Value Added Tax ('VAT')**
  - Sales tax / VAT applicable on permanent transfer / grant of right to use IPR
  - Only specified IPR liable for sales tax / VAT. The list differs from State to State
  - Sales tax / VAT levied in the State in which transfer of IPR takes place (Judicial precedents)

Contd…

Taxation Aspects

- **Service tax**
  - Service tax applicable under the categories 'Intellectual Property Service' and 'Franchisee Service'
  - Service tax under the category 'Intellectual Property Service' levied on transfer of right to use following IPRs:
    - trade mark
    - patent
    - any other similar intangible property under any law for the time being in force

Taxation Aspects

Indirect Tax Implications

- Service tax under the category 'Franchisee Service' levied on grant of representational right to sell or manufacture goods or to provide services or undertake any process identified with franchisor, whether or not a trade mark, service mark, trade name or logo or any such symbol, as the case may be, is involved

- ***No service tax*** applicable on grant of right to use copy right or outright transfer of IPR under the category 'Intellectual Property Service'

Caveats

- Aforementioned contents are only to provide a broad overview of the subject from a financial perspective
- Application of the principles would differ on facts and circumstances of each case
- Does not constitute advice or a recommendation. Please consult the experts for situation specific advice on any matter

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Thank You