ASSOCHAM -
National conference on
‘A Scientific Art of Valuation’

Fair Value, Intangible and Purchase
Price Allocation

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Agenda

• Purchase price Allocation – An Overview

• Valuation for PPA

• Key considerations in Intangible Valuation
Purchase Price Allocation – An Overview
Introduction

Accounting for business combination based on IFRS, US GAAP require allocation of consideration paid to tangible and intangible assets acquired.

Consideration paid for acquisition

<table>
<thead>
<tr>
<th>Allocated to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible assets</td>
</tr>
<tr>
<td>Intangible assets</td>
</tr>
<tr>
<td>Goodwill</td>
</tr>
</tbody>
</table>

In proportion to their Fair Market Value

Such allocation requirement driven by Transparency to stakeholders for consideration paid for business combinations.
Requirement and identification

**Tangible assets**
- Net Current Assets
- Fixed assets

**Intangible assets**
- Identify intangible assets based on accounting standard requirements

**IFRS 3/3R & FAS 141R on Business Combinations**

Critical attributes of an intangible:
- Identifiability, which includes
  - Separability (or)
  - Contractual rights
- Measurability
- Control
- Future economic benefits

PPA mostly involve valuation of intangible assets since in many cases tangible assets considered at book value
Importance of Intangible Assets

Intangible Assets generate...

- Brands
- Royalties

Create Entry Barriers

- Patents
- Trademarks

Revenue Enhancement

Cost Savings

- Know-How
- Trade Secrets

Competitive Advantages
Intangible Assets drive Market Value

Categories
- Marketing Based
- Customer Related
- Artistic Related
- Contract Based
- Technology Based
What are implications?

Internally Generated Assets

- Goodwill

Not Recognised

Not Amortised
Impairment Test

Acquired Intangible Assets

Arising from Contractual or Legal Rights

- Finite Lives
- Indefinite Lives

Amortised
Impairment Test

Not Amortised
Impairment Test
Purchase Price Allocation – Process

STEP 1
Business / Enterprise Valuation to estimate IRR / WACC

STEP 2
Identification of Intangible Assets

STEP 3
Valuation of Tangibles and Intangibles

STEP 4
Allocating Value

STEP 5
Reconciliation of Results
# Categories of Intangible Assets

<table>
<thead>
<tr>
<th><strong>Customer Related</strong></th>
<th>Intangible assets that relate to customer structure or customer relationships of the business</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Customer relationships</td>
</tr>
<tr>
<td></td>
<td>• Order or production backlog</td>
</tr>
<tr>
<td></td>
<td>• Customer list</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Technology Based</strong></th>
<th>Technology-based intangible assets relate to innovations or technological advances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Patents</td>
</tr>
<tr>
<td></td>
<td>• Software</td>
</tr>
<tr>
<td></td>
<td>• Know-how</td>
</tr>
<tr>
<td></td>
<td>• Developer technology</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Contract Based</strong></th>
<th>Intangible assets that have a fixed or definite term which is agreed upon by both parties and written in the contract</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates</td>
</tr>
<tr>
<td></td>
<td>• Licensing, royalty, standstill agreements</td>
</tr>
<tr>
<td></td>
<td>• Advertising, construction, management, service or supply contracts</td>
</tr>
<tr>
<td></td>
<td>• Lease agreements</td>
</tr>
<tr>
<td></td>
<td>• Construction permits</td>
</tr>
<tr>
<td></td>
<td>• Franchise agreements</td>
</tr>
</tbody>
</table>
## Categories of Intangible Assets

<table>
<thead>
<tr>
<th><strong>Marketing Related</strong></th>
<th>Marketing-related intangible assets are those assets that are primarily used in the marketing or promotion of products or services</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Trademarks</td>
</tr>
<tr>
<td></td>
<td>• Brands</td>
</tr>
<tr>
<td></td>
<td>• Internet domain names</td>
</tr>
<tr>
<td></td>
<td>• Non-compete agreement</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Artistic Related</strong></th>
<th>Artistic-related intangible assets meet the criteria for recognition apart from goodwill if the assets arise from contractual rights or legal rights such as those provided by copyright</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Plays, operas, ballets</td>
</tr>
<tr>
<td></td>
<td>• Books, magazines, newspapers, other literary works</td>
</tr>
<tr>
<td></td>
<td>• Musical works such as compositions, song lyrics, advertising jingles</td>
</tr>
<tr>
<td></td>
<td>• Pictures, photographs</td>
</tr>
<tr>
<td></td>
<td>• Video and audiovisual material, including motion pictures, music videos, television programs</td>
</tr>
</tbody>
</table>
Valuation for PPA
What is Fair Value?

Appendix A of IFRS 3
The amount for which

- an asset could be exchanged or a liability settled,
- in a current transaction
- between knowledgeable, willing parties,
- in an arm’s length transaction

Appendix F - Glossary of FAS 141
The amount at which

- an asset (or liability) could be bought (or incurred)
- in a current transaction
- between willing parties,
- that is, other than in a forced or liquidation sale

Appendix A of IFRS 13
The price that would be received

- To sell an asset or paid to transfer a liability,
- in an orderly transaction
- between market participants,
- At the measurement date
Approaches to estimate Fair Value

**Income / Economic Value Approach**
Based on the present value of expected future earnings / cash flows to be derived from ownership of the asset

- Excess Earnings
- Relief from Royalty
- Discounted Cash Flow
- Comparative Business Valuation

**Cost Approach**
Based on the cost to reproduce or replace the asset

- Historical Cost
- Replacement Cost

**Market Approach**
Based on transactions involving the sale or license of similar assets in the marketplace
Key Considerations in Intangible Valuation
WACC for Intangible Assets

• Required rates of return attempt to estimate the return a typical investor would require
  – Dependant on perceived risk, liquidity

• The weighted average cost of capital or “WACC” is the required return on a business entity’s invested capital

• The component assets of a business require different returns
  – Disparate returns reflect differences in perceived risk and liquidity

  – Intangible assets are often considered the highest risk assets of a business enterprise due to:
    – Lack of versatility
    – Illiquidity
    – Susceptibility to competitive forces

  – Goodwill generally has the highest required rate of return
    – Usually appears last in the development of a business
    – Disappears first in a business demise
WACC for Intangible Assets

- In these instances, the required return for Intangibles can be estimated as a premium to the WACC or the cost of equity of the company.
Remaining Useful Life (RUL)

• Definition
  – The period over which an asset is expected to contribute to future cash flows

• Determine RUL based on an analysis of:
  – The expected use of the asset by the target
    – Should not consider buyer’s intent (i.e. abandonment)
  – The expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate
  – Legal, regulatory, or contractual provisions that may limit the useful life or enable renewal or extension of the asset’s legal or contractual life without substantial cost
  – Effects of physical deterioration, functional obsolescence, technological obsolescence, and economic obsolescence
  – Estimation of the future benefit derived from the intangible asset
Remaining Useful Life (RUL)

- Level of **maintenance expenditures required** to obtain the expected future cash flows from the asset

- Level of **capital investment required** to maintain

- Asset’s position in **industry** or **product lifecycle**

- **Competitive forces**

- Market conditions
  - **Changing consumer preference** or asset use

- Rate of **technological change**

- Renewal patterns

- Historical pattern
Tax Amortization Benefit (TAB)

• Identified intangibles are typically **amortizable for tax purposes:**
  – If acquired in isolation, Indian tax laws allows companies to amortize only certain Intangible assets such as: Know-how, patents, copyrights, trademarks, Licenses, Franchises, or any other business or commercial rights of similar nature
  – Must consider local tax regulations

• Amortization usually results in a tax-deductible expense (**depending on country**)

• Amortization reduces taxable income and the resulting **tax savings** should be included in the fair value of the asset when performing an income approach and cost approach valuation

• “Circular” –
  – Need fair value of asset to estimate TAB
  – but need TAB to estimate fair value of asset
  – Can avoid circular references by using a tax amortization benefit factor calculation
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