偉華咨詢有限公司
VAL Consulting Limited

Valuation of Intangible Assets

Purchase Price Allocation

Accounting Standards Compliance

Accounting for business combinations is regulated by the International Accounting Standards Board (IASB) in IFRS 3 and the US Financial Accounting Standards Board (FASB) in SFAS 141. Hong Kong Institute of Certified Public Accountant (HKCPA) has issued its respective standards for HK-incorporated companies in HKFRS 3 based on IFRS 3. In short, these standards require a business combination to be accounted by the acquisition method. The "pooling of interests" method has been discontinued.

This requires the purchase price (of a business) to be allocated to identifiable assets and liabilities at fair value at the acquisition date and to be recognised in the acquiring company's consolidated balance sheet. This accounting standard requirement is formally known as the Purchase Price Allocation (PPA).

The PPA process involves determining the purchase price, identifying hidden reserves and charges reflected in the assets and liabilities shown in the acquiree's balance sheet, as well as identifying and valuing intangible assets (IAs) and contingent liabilities previously not recognised in the balance sheet at fair value.

Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties, in an arm's length transaction.

Identification and Valuation of Intangible Assets

PPA can add value, if properly conducted

Other than the obvious Standards compliance reason for audit purpose, getting the PPA process right has financial and economic implications to the acquiring company particularly in relation to the IAs aspect.

Recent empirical studies of listed companies show that IAs represent a significant value component of a business in today's economy. This is especially the case for businesses related to the information, software, technology and service industries. IAs such as trademark, patent, customer relationships, technological know-how etc usually constitute the key value drivers of the acquired company and, they often form the main rationale behind an acquisition.

Getting the PPA process right can add value to the acquiring company in the following ways:

1. Investors are paying increasing attention to scientific justification for a premium price acquisition relative to the acquiree's reported tangible assets. Failure to recognise and value the IAs may lead to negative capital market reaction
2. Identifiable IAs with finite useful life are required to be amortised lowering the company's bottom line. Accordingly, the acquiring company must not overstate the value of IAs
3. A justifiable and accurate valuation of IAs means future impairment not as a result of fundamental change in economic and business conditions can be avoided

4.	It plays a role in optimising the transfer pricing and tax structures
5	It allows management to properly prioritise the importance of IAs and to formulate value enhancement strategy to create further economic value
6	A pre-acquisition PPA allows management to assess the reasonableness of the proposed purchase/asking price from the relative size of its residual goodwill
7	It provides further support to the acquiring company in setting the asking price of the acquired business (or the consolidated business) when it considers to sell in the future

A Compliance and Technical Challenge

In many cases, the fair value of tangible assets such as fixed assets and working capital are easier to be determined than IAs and, can be reasonably represented by the amount recognised in the balance sheet. This cannot be said for the value of IAs which are normally internally generated before the acquisition and therefore are not being recognised and reported.

It is both an accounting standard compliance challenge and a technical/computation challenge to identify and measure the value of the acquired IAs in accordance with the identification and measure criterion required by the Standards. Economic benefits of the acquired IAs are usually appreciated by management in a holistic view whereby their value is bundled with the value of tangible assets and growth opportunities.

In order to identify the relevant and applicable IAs, it requires:

I. A thorough analysis and understanding of a business's value drivers and how they are attributable to certain IAs

II. Whether the identified IAs based on its contribution of economic benefits satisfy the identifiability criterion of IAs as stated in HKAS 38

III. Whether it is *probable* that expected future economic benefits that are attributable to the identified IAs which satisfy the Standards' definition will flow to the company

IV. Whether the cost of the IAs can be measured reliably

HKAS 38 – IAs Identifiability Criteria

An asset is identifiable as an IA if it either

- is separable. I.e., is capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other right and obligations

To value an IA is technically challenging for at least two reasons. First, in many cases, IAs are internally generated and are uniquely vested with the acquiree, it is difficult to find transactions of similar IAs for value referencing. Second, economic benefits attributable to the IAs are usually not directly traceable.

Valuation Methodologies for Intangible Assets

An Overview

The Standards provide limited guidance on how to determine the fair value of IAs. The valuation methodologies that are generally accepted by the mainstream auditors and practitioners are:

Market Approach – it values IAs by making references to transactions of the same assets that occurred recently in similar markets that are reasonably active. Alternatively, it adopts the price/value of comparable transactions and makes necessary adjustments to reflect the differences between the acquired IAs and the comparable IAs

This approach can provide the best evidence of fair value because it relies on evidence from actual market transactions. However, outright transactions of IAs are infrequent and similar/comparable IAs are rare. Therefore, this approach is difficult to apply in practice and is not commonly used in the PPA valuation of IAs.

Income Approach – it values IAs by discounting the future economic benefits (i.e., cash flow) expected to be generated by the IAs over its estimated remaining useful life.

There are various valuation methods under this approach including the multi-period excess earnings method (MEEM), the incremental cash flow method and the relief from royalty method. Applying these methods require complex modelling skill and extensive research of certain assumptions as required by these methods to enable proper value computation. This approach is mostly used in practice.

Cost Approach – it values IAs by assessing the reproduction (redevelopment) costs or replacement costs of the asset.

This approach is normally used when no cash flow can be assigned to the IAs. It is often used to value internally developed software of system supporting nature. Notice that, the cost of recreating or replacing an asset is not necessarily an accurate indication of the future value of that asset. However, it serves as a useful value benchmark.

How We Can Help

In conclusion, conducting a PPA valuation of IAs is a complex and technically challenging exercise. It requires thorough analysis and understanding of the acquired business with respect to the IAs, familiarity with the identification and measure criterion as stated in HKAS 38 and, competent financial modelling skills in the application of various valuation methods.

VAL Consulting has extensive knowledge and experience in providing PPA valuation of IAs for companies of various industries. We are confident that we can assist management to meet the PPA-related audit requirement and to optimise the IAs' economic benefits to the business.

Contact Information

偉華咨詢有限公司
VAL Consulting Limited

Alan Thu

Tel: +852 3796 2620

Mob: +852 6226 6975

Email: alan.thu@val.com.hk