

## About The Author –

Excedor Valuers Pvt Ltd – Registered under Land & Building and Securities & financial Assets – IBBI/RV-E/02/2020/130

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### Detailed Procedure for Valuation of intangible Assets in Purchase price Allocation

#### Introduction:

Ind AS 103 is applicable in case of business combinations. Business combinations are defined as:

When a transaction where the assets acquired and liabilities assumed together constitute a business, then such transaction can be identified as a business combination.

E.g., Merger, de-merger, slump sale, etc.

#### Objective of this Ind AS?

*It is to improve the relevance, reliability, and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects. To accomplish that, this Ind AS establishes principles and requirements for how the acquirer:*

- a) *recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree.*
- b) *recognizes and measures the goodwill/ capital reserve acquired in the business combination or a gain from a bargain purchase.*  
*and*
- c) *determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.*

#### Recognizing and measuring the Identifiable Assets and Liabilities -

The acquirer shall have to recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree, subject to fulfilment of conditions as prescribed.

- i. All tangible assets excluding property, plant and equipment and liabilities assumed shall be recognized at the realizable value.
- ii. All property, plant and equipment and liabilities assumed shall be recognized at the fair market value.
- iii. Further, the acquirer may have to recognize some of the assets and liabilities that were not recognized earlier in the books of acquiree. These consists of intangible assets such as franchises, trademarks, patents, copyrights, mineral rights, customer contracts or relationships, etc. that grant rights and privileges, and have value for the owner.

Intangible assets are assets in addition to financial and tangible assets and working capital. Under Ind AS 38 an intangible asset is defined as “An identifiable non-monetary asset without physical substance”. From an accounting perspective, it has the following key attributes:

- identifiability - they are separable or may arise from contractual or other legal rights,
- future economic benefits – their existence depends on expectation of future benefit such as revenue or cost savings or other benefits resulting from their use; and
- control - the owner can control the use or restrict the access to the future economic benefit

The following are some of the common types of Intangible Assets which are obtained during a Business Combination:

1. Brand

Brand is derived from consumer perception for that company. It is a value premium which a company receives from its products or services as compared to another product or service in the same industry. Depending on the company, the brand name can be critical to the success of the business. When a company has a positive brand value, customers may be willing to pay a high price for its products, even if they could get the same thing from a competitor for less.

2. Intellectual Property

It is one of the important types of intangible assets, which is a registration of creativity; it might be in technology or design. These are the most valuable assets of any corporation. It is also referred to as inventions or unique designs. The owners legally protect these inventions or designs from outside uses without consent.

The companies should be aware of the value of these intellectual properties the same as another kind of physical property, as the value of the intellectual property are huge when it compares to physical property. There are 4 different types of intellectual property:

- i. Patents: Protection of new technologies from using or developing by others. For example, Samsung wireless charging technology.
- ii. Copyrights: Protection of authorship from using and publishing by others; For example, most of the books published in the world cover copyrights, prevent others not to publish without consent of the author.
- iii. Trademark: Protection brand names, logo, or unique designs of the company. For example, Logos or product designs are protected from trademarks.
- iv. Trade Secrets: Protection of secret information of a product from using by others.

Research and development (R&D) is another type of intellectual property (IP) and refers to when a company performs research with the goal of developing a new product or solution. IP and R&D go together because the research alone may or may not produce a valuable asset, but the development side will.

3. Customer Contracts / Relationships

A list of the regular / repetitive customers can be considered as an Intangible asset of the company. It takes a long time to build a customer relationship and can have a significant future value for any business because it can help in future segment targeted marketing for new or the same products or services and help in gaining new businesses.

4. Licensing and Rights

These are other kinds of intangible assets that are widely used in business. Licensing and Rights are the agreement between an intellectual property owner and others who are authorized to use those intellectual properties for their business purpose in exchange for an agreed payment, which is called Licensing fee or Royalty.

A license gives the holder certain rights of using or generating revenue from someone else, business, or inventions.

5. Non-Compete Agreements

Non-compete agreements may reduce the risk of the acquired business losing customers to the vendor. They might also prevent the vendor from seeking to recruit key employees of the acquired business, thereby reducing future recruitment, and training costs and improving the retention of know-how within the business. Non-compete agreements may therefore represent future economic benefits in the form of higher sales and lower costs.

### Principle for Measurement

The measurement principle used under Ind AS to value an asset is “*fair value*”, which means that it is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date under current market conditions. While it emphasizes a market-based measurement, it is likely that the observable market data may not always be available. In such cases, valuation techniques maximizing the use of relevant observable inputs should be used. The underlying aim is to use assumptions that market participants would employ when valuing the asset, including assumptions about risk, restrictions on its sale or use, condition of the asset, geographical use restrictions, etc.

### Valuation Approaches and Methodologies

The generally accepted valuation approaches comprise of Market Approach, Income Approach, and Cost Approach. Each approach has its own advantages and disadvantages. Thus, depending on the circumstances of each case; for instance: asset type, information availability and quality thereof, risk characteristics, etc. a particular approach might be used. The selection of the approach and methodology is a process of elimination and often the valuer will use more than one method under different approaches to corroborate or set a guideline for an estimate of the fair value. Moreover, depending on the approach and methodology used, the valuation may be predicated on either historical or prospective financial information along with contemporaneously available market data.

The valuation approaches and key methodologies under each are briefly discussed hereunder:

- 1) Market Approach: This approach uses market-based indicators of value. It is based on a relative approach and on the premise of efficient markets and supply & demand. It estimates fair value by reference to observable market price data or transactions of comparable intangible assets. However, given that there is no active market for trading in intangible assets, comparable transactions may be used under this approach. Market data from market participants is often used in income-based models, such as determining reasonable royalty rates and discount rates. There are several databases available in the market to get access to some of these information inputs (e.g., [www.royaltystat.com](http://www.royaltystat.com), [www.upcounsel.com](http://www.upcounsel.com), etc.)

Comparable Transaction Method: Transactions occurring in a free and open market between knowledgeable and willing buyers and sellers conducted on an arm's length basis can be used to determine benchmark metrics for the purpose of valuing the comparable intangible asset. While evaluating comparability, factors such as age of the asset, applicability of use, locational / geographical access or use, risk and expected return characteristics, etc. are considered. Typical benchmarks include multiples of revenue or profitability.

However, while an ideal method, it has limited practical applicability. For one, observable market-based transactions of identical or substantially similar intangible assets are often difficult to obtain. Such transactions are generally confidential and often involve other negotiated terms with respect to marketing, financing, use restrictions, etc. which influence price, but the existence of such arrangements is not publicly known. A further limitation is a lack of comparability - by nature, intangible assets usually enjoy unique characteristic, which almost always necessitates adjustments to be made to the benchmark metric.

Consequently, depending on the quality of data, if available, the method is generally used to corroborate the value arrived at under other valuation methods.

- 2) Income Approach: The income approach uses estimates of future estimated economic benefits or cash flows and discounts them for the associated time and risks involved to a present value. The method is founded on the principal of anticipation – whether of revenue streams or cost savings or

other economic benefit. Thus, it finds maximum applicability in the valuation of intangible assets such as brands, customer relationships, copyrights, patents, etc. which generate a future income or cash inflow stream. However, a key area of difficulty under this approach lies in separating the cash flows exclusively pertaining to the asset under valuation from that of the enterprise.

The discount factors typically used in such instances are the weighted average cost of capital (WACC), or weighted average return on assets (WARA), or the Internal Rate of Return (IRR) of the investor specific to the asset being valued. Thus, depending on the risk and return profile of the asset, a suitable discount factor would be applied to the cash flow stream to arrive at the present value.

This approach includes the following commonly used methods:

- i) Relief from Royalty Method: The Relief from Royalty method is based on the principle that, if the business did not own the asset, it would have to in-license it in order to earn the returns that it is earning. Alternatively, the business could out-license the asset if it did not wish to use it. Thus, the value of the asset is calculated based on the present value of the royalty stream that the business is saving by owning the asset.

Under this method, a royalty that could be expected to be obtained in normal commercial practice is applied to an estimated level of future maintainable sales and the resultant after-tax royalty stream is computed. Such computed after-tax royalty stream is discounted using a relevant discount factor to arrive at the value of the asset.

The method is popularly employed in the valuation of intangible assets such as brands, licences and technical know-how, where transacted royalty rates for similar assets are often available. These rates are then adjusted for asset specific risks and returns such as geographical use restrictions, brand recall, etc. to arrive at a suitable royalty rate.

Pitfalls with rules of thumb: It may be the case that past or current transactions for royalty rates for similar assets may not be available. In such instances, a generally accepted heuristic is the "25%-profit split" method. The 25% Rule as defined by Goldscheider et al (2002) suggests that a licensee should pay a royalty rate equivalent to about 25 % of the expected profits for the product that incorporates the subject IP. The genesis of the 25 % rule was an observation by Robert Goldscheider that the average royalty from a small sample of licensing agreements for a bundle of IP from one company, Philco, reached in the 1950s was about 25% of operating profit. However, this is not backed by reliable evidence. Empirical evidence suggests extremely wide variation depending on the industry. Nevertheless, it still enjoys wide-spread acceptance. Thus, the valuer should be cautious in its use, and should employ it as a cross-check with suitable up/down adjustment and in addition to other data sources to arrive at an appropriate royalty rate.

- ii) Multi-period Excess Earnings Method: Under the multi-period excess earnings method, the present value of the cash flows generated by, and only by, the intangible asset is considered. In order to arrive at cash flows from the intangible asset only, the cash flows generated by the intangible asset in combination with other assets are reduced by subtracting notional cash outflows for the "contributory" assets (the contributory asset charges). This procedure treats the contributory assets as being leased from a third-party, to the extent necessary for the generation of the cash flows. The method is particularly useful in case the intangible asset being valued is a significant value driver with other assets being secondary in nature to it.

- iii) With and Without Method/ Premium Profits Method: This method measures the economic contribution of the asset by calculating the net present value of the incremental cash flows to be derived from the use of the asset. This method requires the determination of the future cash flows from the existing business with the asset and the future cash flows from a notional business without the asset. Non-compete arrangements are commonly valued using this method.
  - iv) Greenfield Method: The Greenfield Method estimates the value of the asset based on the discounted cashflows of a notional start-up business with no assets but the subject intangible. The revenue projections from the identified intangible asset are to be discounted by applying discount rate of such start-up-type discount rate along with incremental risk premium.
- 3) Cost Approach: This approach is based on the economic principle of substitution and covers opportunity costs during the stage of development of the asset as well. However, it ignores the amount, duration and timing of future economic benefit arising from the asset. Further, it does not consider the risk characteristics of the asset nor its performance in a competitive environment. Hence, it is not usually useful in valuing assets such as patents, copyrights, brands, etc. which mainly derive their value from their future earning ability. Nevertheless, it is used when either data required under other valuation approaches is not available or the asset is unique or there is no active market for the asset under consideration.
- The approach is best used in valuing intangible assets such as technical drawings or internally developed software that do not generate a direct cash inflow stream, or assembled workforce; which although is not separately recognized on the balance sheet, is used to arrive at the fair value of other assets). There are two commonly used methodologies under this approach:
- i) Historical Method: This method considers the historic or sunk cost or purchase price to value the asset. This method does not consider future benefits arising out of the use of assets. Hence, it usually is not a good indicator of the true value of the intangible asset.
  - ii) Replacement Cost Method: The method considers estimating the costs to recreate / replace an asset with equivalent functionality at current prices and costs, including adjustments for factors like physical deterioration and functional / economic obsolescence, wherever applicable. It is based on the premise that a prudent third-party would pay no more for an asset than its replacement cost.

#### Tax Amortization Benefit (TAB)

Based on the above methodologies, the valuer arrives at the value of an asset on a stand-alone basis, which is its pre-tax value. However, tax jurisdictions allow an intangible asset to be amortized over its useful life. The present value of such tax benefit is considered in the fair valuation of the asset. The process is iterative considering the amortization period, the discount factor, and the applicable marginal tax rate to arrive at the fair value of the asset post TAB.

#### Conclusion

While it is possible for one method being incorrectly used for the valuation of a specific type of Intangible Asset, there are usually several valuation methods which could be used in deriving an approximate value of the Intangible Asset. The method used generally is based on the reliability and availability of data required for the valuation of the Intangible Asset. Below is the list of the most often methods used in the valuation of Intangible Assets -

Intangible Asset	Relief from Royalty	Excess Earnings	Cost	Greenfield	With or without
Brand	✓				
Patents	✓				
Copyright	✓				
Trademark	✓		✓		
Trade Secrets	✓				
Research and Development			✓		
Customer Contracts / Relationship		✓			
Licensing and Rights				✓	
Non – Compete Agreements					✓

### Illustrative Examples for Stand-alone Intangible Asset Valuation

#### Assembled Workforce - Replacement Cost Method

Particulars	INR Mn
Current Annual CTC of Assembled Workforce	215
Hiring Cost (1 month's CTC)	18
Training Cost (1.5 month's CTC)	27
Inefficiency Cost (50% for 2 month's CTC)	18
<b>Replacement Cost of Workforce</b>	<b>278</b>

#### Brand Valuation - Royalty Relief Method

(INR Mn)

Particulars		2020	2021	2022	2023	2024	Terminal
Net Sales		400	750	1,100	1,400	1,600	1,680
Pre-Tax Relief from Royalty	5.00%	20	38	55	70	80	84
Income Tax	34.94%	7	13	19	24	28	29
After Tax Royalty		13	24	36	46	52	55
Discounting Factor	19.50%	0.84	0.70	0.38	0.22	0.16	0.16
Growth Rate	5.00%						
<b>PV of Cash Flows</b>		<b>11</b>	<b>17</b>	<b>14</b>	<b>10</b>	<b>8</b>	<b>9</b>
Sum of PV of Cash Flows	60						
PV of Perpetuity	61						
<b>Fair Value of Brand</b>	<b>121</b>						

- Royalty Rate is based on prevailing rates charged for brand licence by company to franchisees.
- Discount factor is based on company WACC with adjustment for risk premium for asset

#### Non-Compete Valuation - With and Without Method

INR Mn

Particulars		2020	2021	2022	2023	2024
Cash flows (with Non-competes)		19	24	32	35	40
Cash flows (without Non-competes)		2	5	17	25	33
Difference in Cash flows		17	19	15	10	7
Discount factor	17.50%	0.85	0.72	0.39	0.23	0.16
<b>PV of Differential Cash Flows</b>		<b>14</b>	<b>14</b>	<b>6</b>	<b>2</b>	<b>1</b>
Sum of Differential Cash Flows	38					
Probability of competing	50%					
<b>Fair Value of Non-competes</b>	<b>19</b>					

**Cash flow with Non-compet**

Particulars		2020	2021	2022	2023	2024
EBIT		50	58	65	70	74
Less: Income Tax	34.94%	17	20	23	24	26
<b>Net Income</b>		<b>33</b>	<b>38</b>	<b>42</b>	<b>46</b>	<b>48</b>
Add: Dep		2	2	2	2	1
Less: Capex		12	12	10	10	8
Less: Increase in Working Capital		4	4	3	2	2
<b>Cash flows with non-compet</b>		<b>19</b>	<b>24</b>	<b>32</b>	<b>35</b>	<b>40</b>

**Cash flow without Non-compet**

Particulars		2020	2021	2022	2023	2024
EBIT		20	32	49	56	70
Less: Income Tax	34.94%	7	11	17	20	24
<b>Net Income</b>		<b>13</b>	<b>21</b>	<b>32</b>	<b>36</b>	<b>45</b>
Add: Dep		2	2	2	2	1
Less: Capex		12	12	10	10	8
Less: Increase in Working Capital		2	6	7	3	6
<b>Cash flows without Non-compet</b>		<b>2</b>	<b>5</b>	<b>17</b>	<b>25</b>	<b>33</b>

- Cash-flows are considered for the period of non-compet
- The *dependency* ratio on the non-compet has been considered to arrive at cash flows with non-compet, which reduces with time as follows:

Particulars	2020	2021	2022	2023	2024
<i>Dependency Ratio</i>	60%	45%	25%	20%	5%

- A *probability* that the seller may compete of 50% has been considered to arrive at the Fair Value of Non-compet.

**Customer Relations – Multi Period Excess Earnings Method**

Particulars		FY23	FY24	FY25	FY26	FY27	FY28	FY29	FY30
<b>Total Revenue</b>		24,00,00,000	26,40,00,000	29,04,00,000	31,94,40,000	35,13,84,000	38,65,22,400	42,51,74,640	46,76,92,104
% from repetitive Client		60%	33%	18%	10%	5%	3%	2%	1%
Revenue from repetitive customers		14,40,00,000	8,71,20,000	5,27,07,600	3,18,88,098	1,92,92,299	1,16,71,841	70,61,464	42,72,186
EBIT Margin		45%	45%	45%	45%	45%	45%	45%	45%
EBIT margin before considering asset charge		6,48,00,000	3,92,04,000	2,37,18,420	1,43,49,644	86,81,535	52,52,328	31,77,659	19,22,484
Less: Taxes	25.17%	(1,63,08,864)	(98,66,863)	(59,69,452)	(36,11,518)	(21,84,969)	(13,21,906)	(7,99,753)	(4,83,851)
<b>PAT pre asset charge</b>		<b>4,84,91,136</b>	<b>2,93,37,137</b>	<b>1,77,48,968</b>	<b>1,07,38,126</b>	<b>64,96,566</b>	<b>39,30,422</b>	<b>23,77,906</b>	<b>14,38,633</b>
<b>Less: Contributory Asset Charge</b>									
Fixed asset		92,69,372.0	1,05,29,648.4	60,61,510.4	35,41,927.1	21,03,280.6	12,72,484.8	7,69,853.3	4,65,761.2
Working capital		(11,60,328.7)	7,28,388.7	2,25,704.4	2,62,935.3	3,06,045.4	1,73,374.7	98,216.8	55,639.8
Work Force		11,45,639.4	12,60,203.4	6,93,111.9	3,81,211.5	2,09,666.3	1,15,316.5	63,424.1	34,883.2
Brand		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Content creation		1,17,97,158.0	1,29,76,873.8	71,37,280.6	39,25,504.3	21,59,027.4	11,87,465.1	6,53,105.8	3,59,208.2
<b>PAT post asset charge</b>		<b>2,74,39,295</b>	<b>38,42,023</b>	<b>36,31,361</b>	<b>26,26,547</b>	<b>17,18,546</b>	<b>11,81,781</b>	<b>7,93,306</b>	<b>5,23,140</b>
Discounting factor	18.28%	0.9	0.8	0.7	0.6	0.5	0.4	0.3	0.3
Net present Value		2,52,30,322	29,86,823	23,86,814	14,59,601	8,07,439	4,69,446	2,66,433	1,48,548
Value of Customer list	3,38,81,050								
<b>Fair Value of Customer relation</b>	<b>3,38,81,050</b>								