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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**21 May 2008, London**
Project:	**Annual Improvements Process**
Subject:	**IAS 38 - Measuring the fair value of an intangible asset acquired in a business combination (Agenda paper 5B)**

Introduction

1 Paragraphs 35-41 of IAS 38 *Intangible Assets* provide guidance on measuring the fair value of intangible assets acquired in a business combination. Paragraphs 40 and 41 provide guidance for using valuation techniques to measure fair value when there is not an active market for the asset. Paragraphs 40 and 41 state:

> 40 If no active market exists for an intangible asset, its fair value is the amount that the entity would have paid for the asset, at the acquisition date, in an arm's length transaction between knowledgeable and willing parties, on the basis of the best information available. In determining this amount, an entity considers the outcome of recent transactions for similar assets.
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> 41 Entities that are regularly involved in the purchase and sale of unique intangible assets may have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in a business combination if their objective is to estimate fair value and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, when appropriate:
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> (a) applying multiples reflecting current market transactions to indicators that drive the profitability of the asset (such as revenue, market shares and operating profit) or to the royalty stream that could be obtained from licensing the intangible asset to another party in an arm's length transaction (as in the 'relief from royalty' approach); or
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> (b) discounting estimated future net cash flows from the asset.

2 The staff understands that some find paragraph 41(a) confusing in practice for the following reasons:

a some note that it is uncommon in practice to use valuation multiples to measure the fair value of an intangible asset and, even if it were to be done, paragraph 40 of IAS 38 implicitly addresses their use (see paragraph 2bi for a description of how this valuation technique is applied in practice);

b some note that the description mischaracterises the relief from royalty approach. Paragraph 41(a) states that the entity should apply ‘multiples reflecting current market transactions to … the royalty stream that could be obtained from licensing the intangible asset to another party in an arm’s length transaction’. There are two issues with this:

i valuation practice would not use ‘multiples’ when applying the relief from royalty approach. Valuation multiples represent a <u>value</u>. When using multiples in a valuation technique, the entity uses a quoted price for an asset relative to the asset’s profitability or sales to estimate the value of the subject asset. For example, Trademark T has a quoted price of 30 and revenue of 10. The valuation multiple is 3 times revenue. Entity A owns Trademark Y, which is nearly identical to Trademark T. Trademark Y has revenue of 15. Applying a revenue multiple of 3 would result in a fair value of 45 for Trademark Y. Although this would be acceptable if in fact trademarks had quoted prices, this methodology does not describe the relief from royalty approach.

ii the relief from royalty approach reflects the hypothetical amount the entity saves by owning the asset and therefore not having to license it <u>from</u> another party. This is a different focus from that currently in paragraph 41(a), which looks at the amount received from licensing the asset <u>to</u> another party.[1]

[1] In *Valuing Intangible Assets* (a comprehensive guide to intangible asset valuation commonly used by valuation professionals), Reilly and Schweihs describe the relief from royalty approach as ‘the amount of a royalty or license payment that the intangible asset owner would be willing to pay to an independent third party of the subject asset in order to obtain the use of and the legal rights to the intangible asset’ (p. 114).

c as currently written, IAS 38 could be interpreted as prohibiting the use of a cost approach;[2] and

d the word 'or' between paragraphs 41(a) and 41(b) implies that 41(a) does not consider the present value of the licensing income in the relief from royalty approach (in other words, paragraph 41 reads as though (a) and (b) are mutually exclusive when in fact the relief from royalty approach uses a discounted cash flow methodology[3]).

3 The staff understands that some in the valuation profession do not rely on the guidance in paragraph 41(a) because it does not describe commonly-used valuation techniques in the manner in which they are used in practice. Instead, they rely on the principle underlying the paragraph—that is, that entities may use valuation techniques consistent with the objective of estimating fair value when there is not an active market for the intangible asset.

4 The staff is concerned about those who do not have valuation experience. A literal reading of paragraph 41 could lead preparers to measure fair value inappropriately and/or their auditors to require it to be done that way. This is of increasing concern as countries continue to adopt IFRSs and try to familiarise themselves with the literature, particularly in less developed economies where they do not have the valuation expertise either to know how to do it or to challenge the auditor who requires it to be done exactly as written in IAS 38.

5 Therefore, the staff thinks it is important to clarify the wording to characterise properly the valuation techniques that can be used.

Staff recommendation

6 The staff thinks there are two ways to resolve this issue:

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[2] The 'cost approach' is not defined in IFRSs although IAS 16 *Property, Plant and Equipment* refers to it in its description of valuation techniques that can be used in the absence of market-based evidence of fair value (IAS 16.33). FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) states that 'the cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost)' (SFAS 157.18(c)). In practice, this is a commonly-used valuation technique for measuring some types of intangible assets.

[3] In fact, the relief from royalty approach is an income approach, not a market approach. Paragraph 41, as written, implies that it is a market approach.

a the Board could address it in the fair value measurement project. That project will compile all (or nearly all) fair value measurement guidance into a single IFRS. Presumably paragraphs 35-41 of IAS 38 will be removed from IAS 38 and placed into the fair value measurement standard; or

b the Board could address it in the annual improvements process.

7 The staff recommends addressing it in the annual improvement process for timing reasons. The Board currently expects that a fair value measurement standard will be issued in 2011 with an effective date yet to be determined, but it is unlikely to be before 2013. If this issue is addressed through the annual improvements process, the guidance in paragraphs 40 and 41 of IAS 38 could be fixed in 2009 and with a likely effective date of 2010.[4] This also addresses the staff's concern in paragraph 4 above.

8 The appendix contains the proposed drafting for the amendments.

Questions for the Board

9 **Does the Board agree that IAS 38 should be amended as part of the annual improvements process?**

10 **Does the Board agree with the proposed amendments to paragraphs 40 and 41?**

11 **Does the Board agree that the proposed amendments should be applied prospectively as proposed in paragraph 130D?**

[Appendix omitted from observer note].

[4] This ignores the possibility of delays in the fair value measurement project. Any delays in that project would result in the delay of improving the guidance for measuring intangible assets (and removing it from IAS 38).