

IVSC invites comments on the following:

2.1.1 Do you consider that there is a need for guidance in respect of the valuation of intangible assets for IFRS purposes?

Yes. However, even though the paper sets out to provide guidance specifically for valuations for IFRS purposes, the guidance should also strive to address valuations under U.S. GAAP. We believe that would be desirable for several reasons:

- Valuers and preparers completing valuations for financial reporting in different jurisdictions would likely be interested in understanding any differences in such valuations.
- Given the prospect for a possible single global set of accounting standards, guidance on valuations for financial reporting should aim to be broad-based at this time in order to educate and prepare for such move in the near future.
- In order for the Paper to gain wider acceptance currently, and given current practice issues, intangible asset valuations under U.S. GAAP should also be addressed.

In order to accomplish the above, we suggest that the Paper include, at a minimum, a section that discusses *differences* in the valuation of intangible assets for financial reporting purposes under IFRS and U.S. GAAP, if any.

2.1.2 Do you consider that the guidance given in this Paper is at the right level of detail or should there be additional or less detail?

We believe that the Paper is fairly general and should be more technical. The discussion of the issues currently is at a rather high level, so while the Paper does provide someone with little or no experience in intangible asset valuation with a background in such analysis, it does not delve into issues and controversies which valuers currently face. The goal of the Paper should be to decrease diversity in practice.

Further, the Paper needs to strike the right balance between corporate finance/quantitative techniques and interpretation of the requirements of valuations under IFRS. We feel this is also an area for improvement.

Also, the Paper seems overly focused on the market and cost approaches with relatively less discussion related to the income approach and its variations. In practice, the most material intangible assets are valued through the application of the income approach, and predominantly so by the use of the multi-period excess earnings method. While this approach is addressed, the Paper seems to portray it as the method of last resort.

2.1.3 Do you consider that the Paper achieves the intentions set out in paragraph 1.4?

No. The guidance contained in the Paper is at times flawed (examples are summarized in the Appendix to this letter) and not aligned with current valuation practice. In that regard, the paper might be confusing to practitioners and the IASB if relied upon in its current form during the Board's deliberations on fair value measurements.

The references to Statement 157 do not provide sufficient discussion or interpretive guidance, as paragraph 1.4 claims. For example, more detailed discussion of the appropriate unit of valuation (the business as a whole) and how the intangible assets should be evaluated in the context of the unit of valuation would be helpful.

2.1.4 Do you agree that any future guidance issued by IVSC on this topic should be principles based, with detailed discussion of different methods and illustrative examples clearly distinguished in a Technical Paper?

Yes, although it might be worth considering the use of appendices to provide illustrative examples and referencing them in the Paper to provide a comprehensive document.

2.8 Questions regarding technical valuation issues

2.8.1 Do you agree with the approach taken as regards each of the issues set out in paragraphs 2.6–2.8 above?

No. The existence of Statement 157 is a reality and to not address it in the aggregate detracts from the significance of this Paper.

Interpretive guidance on Statement 157 would greatly benefit the IASB in their deliberations of Fair Value Measurements, as well as other interested parties. Further, considering some aspects of Statement 157 in this Paper, but not others, would perpetuate confusion on the issues. Finally, some of the Statement 157 concepts that have not been addressed in this Paper (for example, valuation premise and highest and best use) have been a precept in the appraisal industry for many decades prior to issuance of FASB's Fair Value Measurements statement.

2.8.2 In particular, do you consider that 'inactive market' is a suitable term? If not, which other term would you use for an 'inactive market'?

The term in and of itself is reasonable. However, as used in the Paper, it ignores the issue of the interplay between the unit of valuation and the market for that unit of valuation (i.e., there may be more activity in the market on the level on which the subject intangible would be grouped and sold with other assets). This is another example where a reference or interpretation of “Statement 157 concepts” might be helpful.

2.8.3 Do you agree with the guidance in respect of entity-specific factors in paragraphs 4.25 et seq.? Do you consider that any additional guidance is required in respect of entity-specific factors?

Note that paragraph 4.25 describes entity-specific factors as “**attributes** of an intangible asset that vary according to the party owning the asset” [emphasis added]. Because of their nature, and because they vary uniquely among entities, entity-specific factors should not be referred to as an *attribute of the asset*.

Since more often than not intangible assets are bought and sold in conjunction with other assets or as part of a business, it would be very helpful to have a discussion of a working presumption that the transaction and the intended use of the assets by the buyer should be considered a market participant view unless entity-specific attributes of the transaction can be identified.

2.8.4 Do you agree with the approach taken in this Paper, paragraph 4.32 with regard to the aggregation of identical and similar assets that form a portfolio?

We believe that that by acknowledging that for some intangible assets “it may be either impossible or impractical to value them other than in conjunction with other tangible or intangible assets”, paragraph 4.32 raises the issue of *valuation premise*. This is another strong indication that the valuation premise, in-use and in-exchange, ought to be discussed in the Paper as part of the overall framework.

It also seems that too much emphasis is being placed on the “reliably measurable” criterion in IAS 38 (related to the same in IFRS 3). Considering that this criterion will be eliminated when the new business combinations statement comes into effect, it seems that the discussion might create confusion as it is rooted in past practice that will soon become history, and might be opening the door too wide for exceptions to fair value measurement on the grounds of “not reliably measurable”. We suggest a more forward-looking view on the issue, where current practice is only briefly mentioned, rather than being so central to the discussion. The reality is that, even in current practice, intangibles could generally be measured no less reliably than certain other assets; although occasionally the valuation may be more difficult, it would not be impossible.

Otherwise, the discussion in paragraphs 4.33 – 4.45 related to 4.32 is generally insightful and helpful. The primary rationale for grouping assets is the similarity in useful lives and the ultimate impact on the amortization of the asset(s). This should be further emphasized in the discussion. In addition, a discussion about amortization methods (such as the pattern of economic benefit) would assist in putting the aggregation issue in context. Furthermore, potential Day 2 impairment issues also may have an influence on the level of aggregation of the assets. Including such a discussion would be beneficial.

2.17 Questions regarding intangible asset valuation methods

2.17.1 Do you agree that these are the five most regularly used methods for valuing intangible assets?

Yes, however the order of their presentation infers a certain priority in their use. The market transaction method is rarely applied, other than in the assessment of a royalty rate (which is ultimately an input to an income approach), but it is the first method mentioned. The least emphasis throughout the document has been placed on the multi-period excess earnings method which infers the lowest reliability and least frequent use, contrary to current practice.

2.17.2 Do you think that there are any other valuation methods that should be covered?

For the purposes of this document, a clear definition and discussion of the stated approaches would be a significant step in creating a standard. Other minor approaches or variations of the stated approaches can follow in future revisions or additions.

2.17.3 Do you think that the description of each method is sufficient or do you think that further details are required for any of the methods?

As stated prior, the discussion regarding the multi-period excess earnings method needs to be expanded as it is the most prevalent of approaches. Issues such as whether the asset is the enabling asset, the relationship between assets and contributory asset charges, proper apportionment of expenses, analysis of the intangible cash flows in the context of the business, etc. should be elaborated on.

The detailed examples in the benchmarking section infer greater reliance on other approaches. In addition, there are some misstatements in the discussion, some of which we summarize in the attached Appendix.

2.17.4 Some simple examples regarding the intangible asset valuation methods are included. Do you consider that these examples are sufficient or do you think that more detailed examples should be included?

The multi-period excess earnings method would benefit from a more detailed example. Further, simple numerical examples of the application of all the approaches could be included in an appendix of the Paper, as an illustration.

The general reference to “capitalized” cash flows is confusing and it may be more appropriate to refer to “discounted” cash flows. Capitalization implies a normalization of cash flows, which may not be an appropriate assumption in all intangible asset valuations.

Capitalization is used primarily in real estate appraisal; in the field of intangible asset valuation, cash flows (which often vary during the projection period) are *discounted* to present value. Also, in the context of valuation of an intangible asset over a finite period (which is most often the case), it is more difficult to convey and illustrate the concept of an *annuity factor*, which is what the capitalization multiple represents when limited to a specific time period (when not related to cash flows in perpetuity).

2.17.5 Do you agree with the approach taken in this Paper with regard to the tax amortization benefit, as set out in paragraphs 5.25-5.28?

The current example is confusing. A simple chart that shows the iterative process may be more effective, and may be accompanied by a concise discussion in one short paragraph. In addition, the closed form formula and the derivation thereof to calculate the benefit would be very helpful.

2.17.6 Section V includes an assessment of the possible ways in which reliability might be restricted for each of the valuation methods. Do you agree with this assessment? Do you think that any other factors should be included in this assessment?

We believe that there are similar issues in the reliability of the market approach as there are in an income approach. The market approach requires many subjective adjustments based on the specific attributes of the subject intangible asset and the adjustments are not easily quantified and supported. Intangible assets by definition are unique and subject to their own specific facts and circumstances.

The income approach does benefit from the fact that a majority of the investment decisions are made on the basis of a discounted cash flow analysis and the projections therein serve as the basis for deriving the appropriate PFI for the subject intangible. Therefore, there is some linkage between expected cash flows

for the entity and the purchase price paid. An assessment of the intangible asset's cash flows in the context of the business (or unit of valuation) does, in our opinion, increase their level of reliability.

We do not believe it is appropriate to make inferences about the reliability of valuation methods based on their nature. Their reliability and suitability is a function of the subject intangible asset and the facts and circumstances. In that sense, there is no hierarchy in the valuation methods; the only method/input that would clearly dominate any analysis is a price for an asset in an active market - with the meaning of *a market in which transactions for the asset occur with sufficient frequency and volume to provide pricing information on an ongoing basis*. In our experience, that is rarely, if ever, the case for an intangible asset

2.19 Questions regarding valuation inputs

2.19.1 Do you agree that each of these eight key valuation inputs should be addressed?

We do not agree with the level of input aggregation in the discussion. For example, “capitalization factors” are a function of the discount rate (an input) and the period of capitalization (also an input). The input described as “contributory asset charges” is a function of the value of the contributory assets, rates or return, etc. Replacement cost in turn may also comprise a number of inputs. Premium profits are a function of a multitude of inputs as well – in some cases, they are the difference between two PFIs.

In general, we recommend a more “disaggregated” approach, and more simplicity (that is, the discussion should stick to the very basics of inputs).

2.19.2 Do you think that any additional valuation inputs should be addressed?

See our earlier comment.

2.19.3 Do you think that sufficient guidance is provided in respect of each of the eight valuation inputs?

See our earlier comment. Apart from that, the guidance in particular on the contributory asset charges is insufficient and at times incorrect. The discussion of capitalization multiples and the formula derivations may be confusing to many (if included, they should be in an appendix).

2.19.4 Do you think that there are any additional benchmarking processes that should be included?

No. Some of the current benchmarking gives the appearance of a mechanical process and a false impression of reliability and completeness in the supporting data when there is not much of that. Further, we suggest streamlining and shortening the accompanying discussion.

2.21 Questions regarding selection of valuation methods

2.21.1 Do you agree with the approach regarding selection of appropriate methods that follows an assessment of the relative reliability of data available in respect of eight key valuation inputs, as set out in paragraph 7.34 of this Paper?

No. As stated earlier, any data (except for prices for *identical assets in active markets* – with the meaning of active markets as discussed earlier) is subject to adjustments of varying magnitude and subjectivity. And, in our experience, intangibles assets are generally not traded in such active markets.

2.21.2 Do you consider that this approach is more suitable to the valuation of intangible assets than that set out in SFAS 157 with regard to the level of reliability of valuation inputs used?

No. The selection of valuation methods and inputs is a question of judgment, and is a function of the subject intangible asset and the facts and circumstances.

Further, note that notwithstanding the hierarchy in Statement 157, there is a stated overriding objective – to arrive at a measurement that is most representative of fair value. It is in that spirit that even in Level 1, Statement 157 allows adjustments to the observed price if such price is not representative of fair value (refer to paragraph 26 of that statement).

2.21.3 Do you agree that valuers should always seek to support the results from application of a primary valuation method with those obtainable from a secondary valuation method?

Yes, assuming that a secondary valuation method can be deemed representative of fair value. This view should be promoted as a best practice, subject to the facts and circumstances and the nature of the subject intangible asset. There is no substitute for professional judgment.

2.21.4 Do you agree with the proposal in paragraph 7.35 that whenever a valuation method is available without undue cost and effort that such method should be applied as either a primary or supporting valuation method?

No. Sometimes the more costly method is the more appropriate method. Also, occasionally, the method available without undue cost and effort may not be representative of fair value. Consider, for example, auction prices for spectrum licenses, which may be readily obtainable but may understate the value of the license in the context of a flourishing business.

Further, undue cost and effort may have many meanings to different parties, and guidance per above could perpetuate diversity in practice.

2.23 Questions regarding valuation process

2.23.1 In the light of guidance earlier in the Paper, do you think that additional guidance is required in Section VIII?

No. However, a brief discussion of the reconciliation and weighting of the indications of different valuation approaches, and the conclusion of fair value within an indicated range would be helpful.

Appendix of Additional Comments

In addition to our earlier responses to the specific questions of the Paper, the following are general observations on certain paragraphs in the Paper. The comments follow a reference to the paragraph number.

4.18 There is a lack of discussion about the Unit of Valuation being the business as a whole. If one were to limit the markets to those entities that would transact for the individual assets it infers a potential break-up value of the subject entity. For example, there is a market for individual products in a pharmaceutical company; however, the pricing of these products might be based on an incremental rather than a fully absorbed expense analysis. Fair Value based on incremental expenses would overstate the products' value to the detriment of goodwill. Therefore, we believe goodwill should be included the consideration of the grouping of assets, the entirety of which would be maximized through the purchase of the entire business. Not doing so would infer that break-up value is the appropriate basis for measurement and if this were true, the market would reflect more of these transactions. However, this is not the case as a majority of transactions result in the operations of the subject entity continuing and the basis for value is a going concern.

4.23 We observe that if the market for an asset is not active, that does not necessarily result in a conclusion that the market for such asset is hypothetical.

- 4.24 Same comment as in 4.18
- 4.45 The footnote to this paragraph is critical. The issue should be referenced in the body of the Paper rather than in the footnote.
- 4.53 While we understand that it is the expert group’s opinion that Statement 157 is more appropriate for the valuation for financial rather than intangible assets, we believe it is important to note that Statement 157’s *principles* are equally relevant for both financial and non-financial assets and liabilities. However, it is in the area of financial instruments that Statement 157 results in the most significant change to current practice.
- 4.57 The use of an income approach to valuation does not necessarily infer an in-use premise. For example, a bond for which a market price is not available is valued using an income approach. At the same time, the valuation premise for that same bond is likely in-exchange (as a financial asset, the highest and best use of the bond is likely in exchange).
- 5.1.2 The use of the term “capitalization approach” may lead to some confusion. Refer to our related responses to the specific questions in the Paper.
- 5.2 This paragraph highlights the issue of identifying the unit of valuation as the asset or the business. Again, this identification can have a significant impact on the outcome (e.g. incremental versus fully absorbed expense projections).
- 5.27 Refer to our responses to specific questions in the Paper about ways to improve the tax amortization benefit discussion.
- 5.34 This discussion (including the two sub-paragraphs) does not seem correct. It might be clearer to use the terms “Gross Royalty” and “Net Royalty”. As it reads now, if the licensee is responsible for the maintenance expenditure then the royalty is to be adjusted. From the perspective of the owner (licensor) of the intangible asset, the proper treatment would be to deduct the maintenance expense from the royalty stream if the royalty is a Gross Royalty (i.e., if the royalty rate is stated before the deduction of maintenance expense for which the owner is responsible). Conversely, if it is a Net Royalty, or if maintenance is the responsibility of the licensee, no adjustment is required.
- 5.35.2 To the extent that the term “pre-tax discount rate” is used in the Paper it should be defined, as this is an area of confusion and debate.
- 5.38 The relief from royalty example should also include in this paragraph a discussion (or at a minimum reference such a discussion) of assessing the market royalty rates in the context of the PFI.

- 5.39 Incremental profits should be defined as after tax. While the example in 5.43 states this, it would be beneficial to include tax in the definition.
- 5.43 The example may be misleading in its simplicity. There are a number of specific attributes of a Brand and the company that make comparisons quite difficult in the application of this approach. Perhaps the use of an asset valued on the basis of increased manufacturing efficiencies might be preferable.
- 5.46 This paragraph is confusing. Consider rewording it.
- 5.48 This discussion questions the reliability of the contributory assets themselves. To the extent that a conclusion can be reached for the fair value of the underlying contributory assets, this should be sufficient for use in the multi-period excess earnings method and should not deter from its reliability. This discussion infers that the multi-period excess earnings method is inferior to other market or cost approach methods when there is a significant amount of subjectivity in those approaches as well.
- 5.50 CACs are not always calculated as a fixed percent of revenue. The underlying approach would impact the appropriateness of this assumption.
- 5.51 The example of the multi-period excess earnings method is overly simplified. In practice, this approach is generally applied to an intangible asset with a decaying income stream or variable life cycle. The example should be more detailed and based on a specific cash flow projection in conjunction with a discount rate, rather than a capitalization rate applied to a single likely normalized level of cash flow.

Further, if a capitalization multiple is used in the valuation of a finite-lived intangible asset, it should be made clear that the multiple (annuity factor) captures a finite number of periods of cash flows, rather than perpetual cash flows. The multi-period excess earnings method is most often used with finite-lived intangibles.

- 5.56 A discussion of probability-adjusted expected cash flows might be helpful. This approach identifies a specific probability (or probabilities) applicable to the project and applies a discount rate more in line with the WACC (expected rate of return) rather a rate that absorbs all of the risk into the discount rate.
- 5.62 It would be very helpful to contrast the replacement cost approach with the reproduction cost approach, in order to convey the objective of replicating the *current utility* of the asset.
- 5.63 It should be made clear that the use of the replacement cost approach is almost never appropriate for marketable software or patents. While a similar caveat is contained elsewhere in the Paper, the limitations of the approach should be more clearly stated in this discussion.

- 5.64 The price of a “replacement asset in the market” (discussed here as a variation of the cost approach) is in substance an application of the market approach. That point should be conveyed in the discussion.
- 5.65.2 “..[T]he price of a web site in an exchange transaction is *likely to be directly linked* to the cost of developing it” [emphasis added]. Google?
- 5.68 While there is discussion of the inclusion of a tax amortization benefit in connection with the replacement cost approach, there is no mention of whether the costs should be tax-effected.
- 6.6 In practice, most often valuers employ the expected present value method implicitly assuming that the distribution around the mean is symmetrical, which gives the appearance that only one set of cash flows is used. A WACC – an expected rate of return – or a rate in line with the WACC should be used in conjunction with these cash flows.
- 6.8 There is no mention of depreciation in PFI.
- 6.14 This paragraph relates to the issue of defensive value yet is not stated as such. Defensive value is a controversial topic and this discussion oversimplifies the issues. The beginning of the paragraph can also be read as implying that the PFI should be determined without regard to the use of the asset and related profitability in the context of the business. If that were the case there is the potential that the identified “market participant” margins and profitability might exceed that of the entity as a whole and the intangible assets would clearly be overstated. This approach, to the exclusion of the entities own profitability, places complete reliability on the comparability of the market data and none on how the target entity is actually deriving profit from the asset.
- 6.25 The example on benchmarking of a brand using market transactions is not realistic as market transactions for such an asset are rarely obtained.
- 6.59 In this paragraph and elsewhere, the Paper confuses the charges that represent the *return on* an asset and the *return of* an asset (i.e., the descriptions of these two types of charges are reversed).
- 6.64 The discussion of contributory asset charges related to the workforce intangible asset is not correct. The return of the workforce is included in the operating expenses and a return on the workforce is introduced as a CAC.
- 6.65 The CAC would not be based on a hypothetical royalty rate, but rather as hypothetical lease payment under one approach. The last sentence is not at all clear.

- 6.68. The table seems to suggest that a contributory asset charge be taken on *all goodwill*, rather than on a specific component of goodwill (for example, workforce).
- 6.69 A WARA is an approximation of an average outcome. It does not “prove” the reasonableness of the CACs but rather the average relative rates of return on the assets. The WARA discussion should also make it clear as to how the TAB should be treated in the calculation. If the TAB has been included in the asset values, then the purchase price should also be adjusted to include the TAB so as to not misstate the relative amount of residual goodwill. Alternatively, the analysis can be done without the application of the TAB to the assets and cash flows.
- 6.71 The expected value approach is preferable to the traditional approach and should be used whenever the data is available.
- 6.73.2 A direct observation of the *cost of capital* in the market for a business with a similar intangible would be expected to yield an expected rate or return (WACC) rather than a rate that would be used in the traditional approach.
- 6.83.2 It should be made clear that an adjustment to reflect the (finite) life of an asset is in fact performed by the computation of an annuity factor (based on a certain discount rate), rather than an adjustment to the discount rate itself.
- 6.84 The discussion should also touch upon the use of negative growth rates.
- 7.21.1 We strongly advise against a hierarchy of valuation methods. See our earlier responses.
- 7.31 The illustration of documentation in this example is excessive and confusing.