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BUSINESS VALUATION UPDATE

Vol. 21, No. 12, December 2015

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Are International Standards for Intangible Assets Adapted to Most Companies?

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Editor's note: International accounting and reporting standards affect many U.S. companies because of cross-border transactions, M&A activity, and the reporting demands of stakeholders outside the U.S. This article examines the International Financial Reporting Standards (IFRS) and International Accounting Standard IAS 38, which deals with intangible assets—and Section 18 in particular, which is applicable to small and medium-sized enterprises, known as SMEs.

Beyond their differences all over the world, accounting standards share the fact that they mostly deal with past events. Anyone would find this logical. After all, how could a set of norms intended to inform third parties about the financials of a company do otherwise than to rely on the past?

One can easily understand the accounting logic by teleporting back to 1494, when Luca Pacioli edited his mathematics book, which is still the basis of so-called modern accounting standards. At that time, the main goal was to determine what a company had accumulated in terms of its assets, long or short term, since its setup. Another question was how to value a company based on its balance sheet, using amortization and depreciation techniques.

While this remains somewhat appropriate, the world evolves increasingly quickly, not surprisingly first in the U.S., and then 20 years later in Europe. A remarkable development is the exponential expansion of financial markets that consider other elements besides the balance sheets. Another change is that the value of corporations is to be found less in their tangible assets and more in their intangible assets, such as IP ownership or usage rights. Why is that? Because the trend has become not to block funds to support assets but rather to invest in what will create value.

Financial markets anticipate this evolution when they value companies at stratospheric figures compared to the accounting figures. This originates in their feeling or knowledge that such values are elsewhere than in the accounts themselves. Apart from the valuation portion due to speculation, such differences have two sources: (1) a difference between market and accounting values of (in)tangible, visible assets; and (2) the evidence of future value, thanks to extra accounting valuation methodologies and information systems.

At the international level, we notice the emergence of the IFRS/IAS, international standards that rely on the desire to correctly inform third parties not only with an income statement and a balance sheet, but also with future perspectives of the entities.

Among the full set of IFRS (which count around 3,000 pages), International Accounting Standard 38 (IAS 38) relates to intangible assets. In the following pages, we outline the main provisions of this standard before emphasizing the particularities of IFRS for SMEs, a reduced set of international standards applicable to smaller companies.

Introduction and definitions. IAS 38 begins by outlining its scope, then introduces a number

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of concepts, including the definition of an asset, being a resource that is: (a) controlled by the entity as a result of past experience; and (b) expected to generate future economic benefits that will flow to the entity. An intangible asset is defined as "an identifiable non-monetary asset without physical substance."

The list of intangible assets fluctuates over time. Examples include computer software, trademarks, customer lists, supplier agreements, and market share. Spending a lot of money to create such resources doesn't mean you're automatically creating an asset. As long as their counterpart doesn't meet the above three conditions (control, future economic benefits, and identification), they don't contribute to create or increase any intangible asset. IAS 38 states that, without proper identification, such resources become part of the goodwill that is acquired.

An entity controls an asset if it can prevent other entities from reaping its benefits. Usually, such protection comes from legal rights to own or use the said asset. For example, imagine that you own a mine that contains rare raw materials. You may believe that the possibility to extract the raw materials has a value. However, as long as you don't have the legal authorization to exploit the mine, you don't have any control of it and may not claim any intangible asset. IAS 38 provides an example of customer relationships that can be considered as intangible assets for the following reasons: They aren't legally protected or controlled but are separable, and their owning entity has a degree of control over the future economic benefits. Therefore, such customer relationships meet the definition of an intangible asset.

Future economic benefits can be the outcome of sales of products or services, cost savings, or other benefits. But it's not always so clear. When you acquire a right, intellectual property, or patent to prevent a competitor from purchasing and using it, you intend to protect your market share. Can it be considered an intangible asset? What about those patents that are never brought to market, just because they might negatively impact the way companies function? According to IAS 38, the economic benefits should be the consequence of using the resource. Therefore, a protective acquisition not being used won't qualify for the definition of an intangible asset.

Recognition and measurement. IAS 38 states that an intangible asset is recognized when two conditions are met. The first condition is that there is a fair probability that the expected future benefits will flow to the entity. That doesn't mean that all revenues will flow into it, but at least a part of the revenues will. What the norm explains here is that, if the company owning the IP rights knows it won't receive any revenue or cash flow from owning the resource, it shouldn't recognize any intangible asset.

The owning entity shall assess the probability of future revenues using reasonable and supportable assumptions. To do this, the management will estimate the economic conditions and use forecasting tools to support the revenues.

The second condition for recognizing an intangible asset is that its cost can be measured reliably. The reason is that all intangible assets are measured initially at cost. They can be acquired separately or as part of a business combination. The cost of acquiring a separate intangible asset can be determined as its purchase price plus directly attributable costs such as specific salaries, professional fees, or testing costs. However, costs incurred to introduce a new product or service, administration, and general expenses aren't recognized as costs of the said intangible asset, and neither are initial losses and other costs incurred as long as the asset isn't operational as intended.

Recognizing the cost of an intangible asset acquired as part of a business combination should be performed at fair value at the date of acquisition. If there is enough information to reliably measure the value of the asset, then the entity does the calculation. The most valuable information will be quoted market prices and current similar transactions.

Lacking sufficient information, the entity determines the fair value as the amount it would have paid for the asset. IAS 38 also states that entities involved in the purchase and sale of intangible assets may develop techniques for these valuations, such as DCF (discounted cash flows), relief from royalty, or cost replacement methods.

Research and development. Sometimes intangible assets go through a period of research and development even after their acquisition or recognition. As opposed to IFRS for SMEs, IAS 38 makes a distinction between research and development.

Some expenses are incurred to generate future income that will contribute to the growth of the goodwill of the entity rather than contribute to the creation of a specific intangible asset. Such expenses shouldn't be recognized as an asset. Some situations aren't clear to the management as to whether internally generated intangible assets qualify for recognition because the benefit flows or costs can't be differentiated from those of the other assets. Facing such difficulties, the entity will apply these rules:

- Expenditures during the research phases are to be considered as expenses of the period during which they were incurred; and

- Expenditures during the development phase are recognized only when the company can show that the following six conditions are met:

  1. Technical feasibility of the project;

  2. Intention to use or sell the intangible asset once finished;

  3. Ability to use or sell it;

  4. Evidence of future economic benefits generation;

  5. Availability of all resources required to use or sell the intangible asset; and

  6. Ability to measure the expenditure during the development phase.

Note here that, according to IAS 38, internally generated brands, published articles, customer lists, and items similar in substance shall not be recognized as intangible assets. The rationale is that expenditure on such internally generated assets can't be distinguished from the cost of developing the business as a whole.

Measurement after recognition. Once the intangible asset meets the required criteria to be recognized, its cost includes the expenditures required to develop the asset in the "way management intended to," including raw materials and services, wages and benefits, legal fees, amortization of patents, and so on. General indirect expenses—such as administrative, marketing, selling, training expenses, and eventual losses—are not considered components of internally generated intangible assets. Expenditures on intangible assets are recognized as expenses unless they form part of a recognized intangible asset or of the goodwill acquired.

To measure the value of its intangible assets after their recognition, the owning entity chooses between the cost model and the revaluation model as a consistent accounting policy. The cost model is easy to understand: Any intangible asset is carried at its cost less amortization and impairment losses.

With the revaluation model, the entity estimates the fair value (according to the market) at the end of the reporting date, less amortization and accumulated impairment losses. Because intangibles such as publishing rights, brands, and the like are unique and negotiated between individual purchasers and sellers, there aren't active markets for such assets. Moreover, it's rare that prices of such agreements be known to the public. Facing such circumstances, intangible assets are carried at cost reduced by any accumulated amortization and/or impairment losses.

Useful life, amortization, and residual value. The useful life is another important concept in IAS 38. Initially, the entity that owns the intangible asset should assess whether its useful life is indefinite or finite. In a situation of finite useful life, the entity quantifies it in years, units, or any relevant measure. The useful life is defined as indefinite when there is no foreseeable limit to the period of economic benefits flows. To determine the useful life of an intangible asset, the entity considers a series of arguments including the expected usage, life cycle, obsolescence, stability of the market, competition, maintenance requirements, dependence of other assets of the entity, legal constraints, and so on.

When arising from legal rights, the useful life of an intangible asset should not exceed the contractual duration of the agreement. In case of a possibility to renew the legal rights, the useful life includes the renewal period if the renewal doesn't imply significant costs.

An intangible asset with finite useful life is amortized according to a systematic method reflecting the decrease of future economic benefits. The amortization plan can be changed if the useful life appears to be different from previous evaluations. Intangible assets with indefinite useful life aren't subject to amortization. However, the entity reviews and determines whether the useful life remains indefinite at the end of each reporting period.

The company valuating its intangible assets also questions the residual values. IAS 38 states that the residual value of an intangible asset with finite useful life will be zero unless there is a commitment by a third party to purchase the asset or an active market from which a residual value can be developed.

Simpler standards for smaller firms. In the U.S. as well as in European countries, around 95% of all companies are SMEs that cannot absorb such complex accounting standards as IFRS/IAS. Therefore, the International Accounting Board issued a smaller set (less than 300 pages) of accounting standards in 2009. Called "IFRS for SMEs," its Section 18 applies to intangible assets. We will now outline its main points, including the differences with IAS 38.

Both sets of standards define an intangible asset as an identifiable nonmonetary asset without physical substance that has to be separable and arise from legal or contractual rights. Under IFRS for SMEs, an asset needs to comply with three conditions to be recognized as intangible. The first two are identical to IAS 38: the probability of future economic flows and a reliable way to measure the cost. A third condition is added: The asset should not be the result of internally incurred expenditures.

Another difference relates to research or development expenditures. Under IFRS for SMEs Section 18, all expenditures incurred internally for either research or development are considered as expenses of the period. Internally generated brands, customer lists, internally generated goodwill, and the like all have to be reported as current expenses.

As in IAS 38, any entity conforming to IFRS for SMEs measures an intangible asset initially at cost.

As opposed to IAS 38, all intangible assets have a finite life under the SME standard. When arising from legal or contractual rights, the useful life will not exceed the duration of these rights. If the entity is unable to determine the useful life of an intangible asset, the limit is 10 years.

A residual value may be attributed to an intangible asset, as in IAS 38, if a third party commits to purchase the asset or if an active market exists. In other circumstances, residual value will be considered to be zero.

Case study. To demonstrate the standards for SMEs, let's look at the case of Acme Drinks, a fictional European company active in the soft drink market. Searching for growth, the company's board approved an R&D budget in 2012 to create a new original soft drink. The R&D director flew to Africa several times, where she discovered a new and rare variety of berries. She purchased some samples and brought them back to the office.

The team spent 1,200 hours, at an average hourly cost of $100[1] to develop the new soft drink and stabilize its formula. The company hired marketing consultants and conducted consumer focus groups to test the new concoction. Prelaunch expenses totaled $215,000. At the first test by the board, the product was rejected for quality reasons, but at the first board meeting in 2013, the new drink was given the green light. To jump-start sales, the company purchased lists of potential customers and sent each person on the list a coupon for a free sample.

They also decided on an advertising and promotion budget of $700,000 for 2013 and $1.2 million for both 2014 and 2015.

Sales didn't take off as planned, reaching only 7% of the target by the end of the third quarter of 2013. The board decided to end the venture. Instead, it contracted with a leading global manufacturer to purchase the rights to distribute a well-known drink for a period of 15 years. The company paid $5 million upfront, plus royalties at 1.5% of net sales. It budgeted 15% of net sales for advertising and promotion.

Because the company was listed on a European stock exchange (second market), it was subject to IFRS for SMEs. Therefore, it reported its expenses and carried amounts for their intangible assets as shown in Exhibit 1 and explained below:

- All expenditures incurred to create the new "berries" drink were considered as costs in 2012 for a total of $335,000.
- For 2013, the purchase of the customer lists was recognized as an intangible asset because it was controllable and was supposed to generate economic profits. Its useful life could have been fixed at 10 years. However, the company preferred to consider a more cautious useful life of eight years with

1 Being a European company, all figures would be booked in euros instead of USD.

a 12.5% amortization, after considering an upfront write-off of 25%.

- Advertising amount of $700,000 was reported as current expense in 2013. The budget for the following years was not used. Advertising and promotion for the second drink were booked as current expenses in each respective year.

- Even though the $5 million upfront payment for the distribution rights of the substitute drink was for a period of 15 years, Better Drinks amortized it over 10 years according to the international standard, using a linear plan.

- The royalties paid were booked as current expenses in the applicable year.

Exhibit 2 shows the amounts carried on the books as intangible assets for all of the years at issue.

Conclusion. The description and case study above provide evidence that IAS 38 and IFRS

Acme Drinks Europe Intangible Asset Valuation—New Drink Development (US dollars)		**Exhibit 1. Actual and Budgeted Expenditures**								
		2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Research (Drink A)	Internal team, time spent	120,000								
	External fees	215,000								
Development (Drink A)	Customer lists acquisition		1,000,000							
	Advertising *		700,000	1,200,000	1,200,000					
Sales (Drink A)	Forecast		5,000,000	8,000,000	9,000,000					
	Actual sales		350,000							
Substitute drink (Drink B)	Upfront payment			5,000,000						
	Actual sales			3,000,000	6,000,000	9,000,000	9,500,000	9,800,000	10,500,000	10,500,000
	Advertising					1,350,000	1,425,000	1,470,000	1,575,000	1,575,000
	Royalty fees @1.5%			45,000	90,000	135,000	142,500	147,000	157,500	157,500

* 2013 amount is actual; 2014-15 amounts are budgeted

Acme Drinks Europe Intangible Asset Valuation—New Drink Development (US dollars)		**Exhibit 2. Intangible Asset Reporting and Valuation Per IFRS for SME Section 18**								
		2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Recorded as assets	R & D									
	Acquired customer lists*		656,250	562,500	468,750	375,000	281,250	187,500	93,750	0
	Drink B upfront payment			4,500,000	4,000,000	3,500,000	3,000,000	2,500,000	2,000,000	1,500,000
	Intangible asset valuation		**656,250**	**5,062,500**	**4,468,750**	**3,875,000**	**3,281,250**	**2,687,500**	**2,093,750**	**1,500,000**
Recorded as current expenses	R& D	335,000								
	Acquired customer lists*		343,750	93,750	93,750	93,750	93,750	93,750	93,750	93,750
	Advertising		700,000	1,200,000	1,200,000	1,350,000	1,425,000	1,470,000	1,575,000	1,575,000
	Royalties			45,000	90,000	135,000	142,500	147,000	157,500	157,500
	Total	**335,000**	**1,043,750**	**1,338,750**	**1,383,750**	**1,578,750**	**1,661,250**	**1,710,750**	**1,826,250**	**1,826,250**

* Customer lists: $1 million cost; 25% upfront write-off; 8 years useful life

for SMEs favor the cost approach for intangible asset valuation. Even though the existence of future economic flows is verified as a criterion for recognition, they don't allow the use of such forecasts as a basis for valuation. The future income approach, with appropriate valuation methods and formulas, would definitely bring an additional advantage.

Industrial companies that generate profits because of their factories will always need traditional accounting standards. However, service companies of the new era, such as Alibaba or Amazon, have to show different and/or additional information to attract investors and lenders. The emergence of new norms becomes a must at the international level because markets don't value companies such as UberPop based on their past profits but rather on the premise that growth will allow a firm to reach breakeven.

There is no reason to limit this rationale to listed companies. Sooner or later, this evolution will affect SMEs that comprise the heart of our Western economies. Reporting systems need to be adapted to focus more on the future and not exclusively on the past. Between obsolete norms and the workload required by IFRS, a third way remains to be developed: the integration of valuation and reporting methodologies and standards that are based on the future of businesses and usable by most of them. ◆

Charles Markowicz, *CPA, is managing partner at Costmasters, an accountancy and advisory practice based in Brussels, Belgium. Markowicz has a video summary of IAS 38 and comparison to IFRS for SMEs, Section 18, which he is making available to readers of* Business Valuation Update, *free until Nov. 30, 2015. You can reach him at chm@costmasters.com or through Linkedin.*