RICS Professional Standards, Global

The valuation of intangible assets

RICS guidance note

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This guidance note will feature as part of the *RICS Valuation Standards* (the 'Red Book'), due for publication in 2013. It is available here in digital format as a stand-alone guidance note until that time.

Please note that it will only be available in hard copy as part of the Red Book.

The valuation of intangible assets

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RICS guidance notes

This is a guidance note. Where recommendations are made for specific professional tasks, these are intended to represent 'best practice', i.e. recommendations which in the opinion of RICS meet a high standard of professional competence.

Although members are not required to follow the recommendations contained in the note, they should take into account the following points.

When an allegation of professional negligence is made against a surveyor, a court or tribunal may take account of the contents of any relevant guidance notes published by RICS in deciding whether or not the member had acted with reasonable competence.

In the opinion of RICS, a member conforming to the practices recommended in this note should have at least a partial defence to an allegation of negligence if they have followed those practices. However, members have the responsibility of deciding when it is inappropriate to follow the guidance.

It is for each member to decide on the appropriate procedure to follow in any professional task. However, where members do not comply with the practice recommended in this note, they should do so only for a good reason. In the event of a legal dispute, a court or tribunal may require them to explain why they decided not to adopt the recommended practice. Also, if members have not followed this guidance, and their actions are questioned in an RICS disciplinary case, they will be asked to explain the actions they did take and this may be taken into account by the Panel.

In addition, guidance notes are relevant to professional competence in that each member should be up to date and should have knowledge of guidance notes within a reasonable time of their coming into effect.

Document status defined

RICS produces a range of standards products. These have been defined in the table below. This document is a guidance note.

Type of document	Definition	Status
Standard		
International Standard	An international high level principle based standard developed in collaboration with other relevant bodies	Mandatory
Practice Statement		
RICS practice statement	Document that provides members with mandatory requirements under Rule 4 of the Rules of Conduct for members	Mandatory
Guidance		
RICS Code of Practice	Document approved by RICS, and endorsed by another professional body / stakeholder that provides users with recommendations for accepted good practice as followed by conscientious practitioners	Mandatory or recommended good practice (will be confirmed in the document itself)
RICS guidance note (GN)	Document that provides users with recommendations for accepted good practice as followed by competent and conscientious practitioners	Recommended good practice
RICS information paper (IP)	Practice based information that provides users with the latest information and/or research	Information and/or

1 Introduction

1.1 This guidance note reflects the requirements of International Valuation Standard (IVS) 210 Intangible Assets, concerned with the valuation of intangible assets.

1.2 Paragraph C1 in IVS 210 defines an intangible asset as ‘a non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and economic benefits to its owner.’ It is therefore an asset that is capable of being separated or divided from a business entity and sold, transferred, licensed, rented or exchanged individually or with a related asset, liability or contract. Non-identifiable intangible assets arising from contractual or legal rights which may or may not be separable from the entity, or other rights and obligations, are generally termed ‘goodwill’.

1.3 Identified intangible assets include:

- **marketing related assets**: typically associated with, and primarily used in, the marketing or promotion of a company’s products or services (trademarks, brands, trade names, trade dress, internet domain names, newspaper mastheads, non-compete agreements)
- **customer or supplier related assets**: arise from relationships with, or knowledge of, customers and suppliers, and are utilised in the development, procurement, management and maintenance of a company’s customers (customer lists, order or production backlog, customer contracts and related relationships, non-contractual customer relationships)
- **artistic related assets**: arise from artistic products or services that are protected by a contractual or legal right (copyright and design), and giving rise to benefits including royalties from artistic works (plays, operas, ballet, books, magazines, newspapers, musical works, pictures, photographs, videos, films, television programmes)
- **technology related assets**: represent the value of technological innovation or advancements, and can arise from non-contractual rights to use technology, or be protected through legal or contractual rights (patented technology, computer software, unpatented technology, databases, trade secrets, in-process research and development, manufacturing processes and know-how).

1.4 Intangible assets may be either contractual or non-contractual. Contract based assets represent the value of rights which arise from contractual arrangements (licensing, royalty, and standstill agreements; contracts for advertising, construction, management, service or supply lease agreements; construction permits; franchise agreements; operating and broadcasting rights; contractual use rights other than those expressly classified or properly regarded as tangible assets; servicing contracts; and employment contracts).

1.5 A major intangible asset is goodwill. Paragraph C11 of IVS 210 defines goodwill as ‘any future economic benefit arising from a business, an interest in a business, or from use of a group of assets which are not separable’. The benefits that may form part of goodwill include synergies that follow a business combination and are company specific. Examples of this include economies of scale not otherwise reflected in the values of other assets; growth opportunities, such as expansion into other markets; and organisational capital, for instance, the benefits obtained from an assembled network. Goodwill is often perceived to be the amount remaining after the values of other identifiable tangible and intangible assets have been deducted from the overall value of the business.

1.6 Intangible assets are differentiated from one another by characteristics such as ownership, function, market position and image. For example, ladies' fashion shoe brands may be characterised by use of particular colours and styles, as well as price. In addition, while intangible assets within the same class will inevitably have similar characteristics, there will also be aspects that differentiate them from other similar ones.

1.7 The definitions of many of the terms used in this guidance note are from the International Glossary of Valuation Terms, produced by the International Valuation Standards Council (IVSC), and can be found atwww.ivsc.org/~ivscorg/glossary

1.8 To satisfy the *RICS Valuation – Professional Standards 2012* (the 'Red Book') VS 1.6, Knowledge and skills, it is important that the valuer is regularly involved in intangible asset valuation as practical knowledge of the factors affecting any particular asset is essential.

1.9 This guidance note is of global application.

2 Scope of work and terms of engagement

2.1 The valuation knowledge of clients will vary widely. Some will have a thorough understanding of intangible property rights and intangible asset valuation, while others will be unfamiliar with the terms and concepts used by valuers of intangible assets.

2.2 It is imperative that the terms of engagement are understood and agreed between the valuer and the client prior to commencement of the assignment. Any supplementary or contributory assets should be identified and agreement reached on whether they are to be included or not. Contributory assets are those used in conjunction with the subject asset to generate cash flows. Where contributory assets are not to be valued, it is important to clarify whether the intention is therefore for the principle asset to be valued on a standalone basis.

2.3 Valuers may wish to develop standard letters of engagement that can be used for any type of valuation instruction. Where a valuation has to comply with these valuation standards the member must produce terms of engagement that comply with the minimum terms set out in VS 1.4 Terms of engagement and in VS 2.1, Confirmation of terms of engagement adapted as necessary to refer to valuation, as follows:

(a) identification of the client and any other intended users
(b) the purpose of the valuation
(c) the subject of the valuation
(d) interest to be valued
(e) the type of asset or liability, and, how it is used, or classified, by the client
(f) the basis (or bases) of value
(g) the valuation date
(h) disclosure of any material involvement, or a statement that there has not been any previous material involvement
(i) the identity of the valuer responsible for the valuation and, if required, a statement of the status of the valuer.
(j) where appropriate, the currency to be adopted
(k) any assumptions, special assumptions, reservations, special instructions or departures
(l) the extent of the valuer's investigations
(m) the nature and source of information to be relied on by the valuer
(n) any consent to, or restrictions on, publication
(o) any limits or exclusion of liability to parties other than the client
(p) confirmation that the valuation will be undertaken in accordance with these standards and that it also complies with the IVS, where appropriate

(q) confirmation that the valuer has the knowledge, skills and understanding to undertake the valuation competently

(r) the basis on which the fee will be calculated

(s) where the firm is registered for regulation by RICS, reference to the firm's complaints handling procedure, with a copy available on request

(t) a statement that compliance with these standards may be subject to monitoring under the Institution's conduct and disciplinary regulations

Items (a) to (q) in this list of minimum terms and VS 2.2 to VS 2.6 contain all of the requirements of IVS 101, Scope of Work. For a detailed comparison between the two lists, see Appendix 9 (*RICS Valuation – Professional Standards 2012*, March 2012). Items (r) to (t) are additional requirements that apply specifically RICS members.

2.4 For item (c), there may be situations where the interest in the asset to be valued is shared with others, and in such cases, it should be clearly specified.

3 Valuation concepts

3.1 The reason why the valuer has been instructed to perform a valuation is important to understand, as the intangible asset valuation may be required for a wide variety of purposes. Examples include financial reporting, tax, public sector assignments, transactions and flotations, fairness opinions, banking arrangements, insolvency and administration, knowledge management, or portfolio review. The answer will introduce various concepts of value, some governed by statute and case law, and others by international and national standards of professional valuation practice.

3.2 Valuation bases typically encountered for these types of valuations (not all of which are recognised by the IVS or the Red Book) are fair value, fair market value, market value, and open market value. Valuers should be mindful of the requirements of VS 1.2, Compliance, regulation and the requirement to disclose departures, relating to the use of a basis of value not recognised in the Red Book (more specifically, see VS 1.2.7).

3.3 Depending on the rules and practice followed in respect of the concept, the valuation conclusion in respect of the same asset may be different. For example, because of the rules concerning tax valuations, a tax authority could view valuation differently to how a litigant, merger partner or special purchaser would.

3.4 Except in the case where there are strong indications to the contrary, the presumption is that of 'going concern' and that the asset will continue to have a useful life for the foreseeable future. In some cases, this period will be based on what is specified either by law, or under the terms of any relevant agreements or protocols that govern the asset. However, for financial reporting purposes the value of an intangible asset that is to be disposed of, or abandoned, might have to be considered.

3.5 In many cases it may be appropriate to apply more than one valuation method, particularly where there is insufficient information or evidence. In such cases, the valuer may instead use additional methods, adjusted, perhaps on a weighted basis, to arrive at the final valuation.

4 Valuation due diligence

4.1 In line with VS 1.5 Qualifications of the valuer, valuers should have appropriate competency in intangible asset valuation. As a minimum requirement, valuers should not contemplate carrying out a valuation in the absence of a detailed knowledge and understanding of such issues as:

- the rights of the owners of the asset(s)
- the history of, and activities associated, with the asset(s)
- as appropriate, state of the subject industry, general economic outlook and political factors.

4.2 Typical information requirements to assist the valuer in understanding the subject asset(s) could include:

- most recent income statements associated with the subject asset, and details of current and prior projections or forecasts
- description and history of the subject asset, including legal protections and rights associated with it (the extent to which such legal rights have been assessed should be disclosed)
- information about the asset and supporting documentation (e.g. registrations, territorial applications, marketing, technical research and development, documentation, design graphics and manuals)
- other collateral agreements
- details of the precise activities exploiting the intangible asset
- previous valuation reports
- product(s) dealt in, supported or extended by the business and intangibles
- whether anyone else is permitted to use the intangible asset(s), and whether there are plans to do so
- company's market(s) and competition, barriers to entry in such markets, business and marketing plans, due diligence
- licensing, strategic alliances and joint venture detail
- whether contractual arrangements can be assigned or transferred in any intangible asset or royalty agreement
- major customers and suppliers
- objectives, developments or trends expected in the industry and how these are likely to affect the company or asset
- accounting policies
- strengths, weaknesses, opportunities and threats (SWOT) analysis
- key factors (e.g. monopoly or dominant market position, market share)

- major capital expenditure in prospect
- competitor positions
- seasonable or cyclical trends
- technological changes affecting the asset
- vulnerability of any source of raw materials or supplier arrangement
- whether there have been any recent acquisition or mergers in this sector around the valuation date, and the criteria that was applied
- management of research and development (non-disclosure agreements, subcontractors, training and incentives)
- whether there is an intellectual property asset schedule setting out the extent of intellectual property right (IPR) ownership, and the interests of third parties (if any)
- examination of comparable licensing of similar assets.

4.3 It will be necessary, as far as it is possible, to verify facts and information used in arriving at the valuation, and to benchmark company practices and performance against sector best practice

4.4 Much of the information relied on by the valuer will be provided by the client(s), and it may not be possible to verify it. In such cases, the valuation report should make this clear.

5 Valuation methodologies

5.1 In broad terms, valuation theory recognises three distinct methodologies (or approaches) in valuation, including intangibles. These are the market approach (sometimes known as the direct market comparison approach), the income approach, and the cost approach.

5.2 Each approach requires the valuer to adopt an estimate of the asset's remaining useful life. This could be a finite period set by the length of a contract or normal life expectancy in the sector, or it could be indefinite. A number of factors will have to be considered in determining life expectancy, including legal, technical, economic and functional aspects. The presumed life expectancy of an asset that has been licensed for a particular period may be shorter if a superior competitor product is likely to reach the market before the licence expiration. In such case, the valuer would need to take a view on this.

Market approach

5.3 The market approach measures the value of an asset by comparing recent sales or offerings of similar or substitute property and related market data. However, it has to be recognised that it is rarely possible to find such evidence relating to identical assets.

5.4 The two primary market approaches are the 'market multiple method' and the 'similar transactions method'.

5.5 The market multiple method focuses on comparing the subject asset with guideline data such as industry royalty rates. In applying this method, matters such royalty rates are evaluated and adjusted based on the strengths and weaknesses of the subject asset relative to similar assets. They are then applied to the appropriate operating data of the subject asset to arrive at an indication of value. Appropriate adjustments to reflect different properties or characteristics are usually made to the derived data.

5.6 The similar transactions method utilises valuation data based on historical transactions that have occurred in the subject asset's direct or related industries. The derived data are then adjusted and applied to the appropriate operating data of the subject asset to arrive at an indication of value.

5.7 In certain industries, assets are bought and sold on the basis of established market practices or rules of thumb, often (though not exclusively) derived from data or percentages of turnover, and not linked to profit generation. Where such rules of thumb exist, they may need to be considered by the valuer.

Income approach

5.8 The income approach has a number of variants. When applied (using, for example, the discounted cash flow (DCF) method), it measures the value of an asset by the present value of its future economic benefits. These benefits can include earnings, cost savings, tax deductions, and proceeds from its disposal.

5.9 When applied to an intangible asset valuation, value indications are developed by discounting expected cash flows to their present value at a rate of return that incorporates the risk-free rate for the use of funds, the expected rate of inflation, and risks associated with the particular investment. The discount rate selected is generally based on rates of return available from alternative investments of similar type and quality as at the valuation date.

5.10 The income approach also embraces methods such as the relief-from-royalty method, defined in paragraph C24 of IVS 210 as one that estimates 'the value of an intangible asset is determined by reference to the value of the hypothetical royalty payments that would be saved through owning the asset, as compared with the cost of licensing the intangible asset from a third party'.

5.11 There is also the 'multi period excess earnings' method. This is a method of estimating the economic benefits of an intangible asset over multiple time periods by identifying the cash flows associated with the use of the asset and deducting a periodic charge reflecting a fair return for the use of contributory assets'.

5.12 The income approach, as applied using the capitalised earnings basis of value, is common in intangible asset valuation. A thorough understanding of accounting and economic profits, their historical record and forecasting, is necessary in each case.

5.13 Appraisal of intangible assets and IPR includes techniques to identify the earnings specifically associated with the subject asset, such as gross profit differential, excess profits and relief from royalty. Following identification of the profit attributable to the subject asset, capitalisation of earnings and discounted cash flow techniques are adopted.

Cost approach

5.14 The cost approach indicates the value of an asset by the cost to create or replace it with another similar asset. When applied to intangible asset valuation, obsolescence, maintenance and the time value of money are considerations. When the basis of value in the valuation is market value, the indications of obsolescence must be supported by market data.

6 Present value techniques

6.1 Present value techniques (PVT) measure the value of an asset by the present value of its future economic cash flow, which is cash that is generated over a period of time by an asset, group of assets, or business enterprise.

6.2 Issues to consider in relation to this technique include:

- the number of years over which the cash flow is applied
- the capitalisation rate or discount rate applied at the end of the term
- the discount rate(s) adopted
- whether inflation is built into the cash flow
- what other variables need to be considered in respect of the cash flow in the future
- the trading profile of the asset
- initial and running yields, internal rate of return (IRR) and the terminal value.

6.3 Where a PVT approach is applied, it is important that market transactions (i.e. comparables) reflecting the same approach to valuation are taken into consideration. The details of market transactions may be more difficult to obtain where a PVT approach is adopted. However, such transactions will assist in assessing the discount rate to be adopted, the IRR sought and the general approach taken by the market.

6.4 If the valuation is for a specific intangible asset, before undertaking the detailed cash flow modelling, the valuer is required to quantify the remaining useful life and deterioration rate associated specifically with the use of the asset. Typically this remaining useful life analysis will quantify the shortest of the following:

- physical life, for example of an underlying tangible asset
- functional life, for example of an underlying tangible asset
- technological life
- economic life
- legal life.

6.5 PVT valuation will thus involve these key components: a financial forecast identifying specific intellectual capital and associated earnings, and the discount rate (cost of capital). Unsystematic and systematic risk will be considered, and the discount rate determination in its basic application will require identification and application of the cost of capital to known and projected cash flows.

6.6 Discounting appropriately for weighted asset cost of capital and more basic discount rate building will be adopted. The two basic elements of the cost of capital are the cost of debt and the cost of equity. To assist in the calculation of an appropriate rate of return and discount rates, the valuer utilises a number of different methodologies including capital asset pricing model (CAPM), arbitrage pricing theory, and hybrids depending on the particular circumstances.

6.7 Valuers may be required to consider intangible assets in a licensing context, for example, the licensing in or out of technology or patents. Much of what has been covered in this guidance note is relevant in the calculation of an appropriate rate of return in royalty rate calculations. In practice the rate is estimated by reference to some or all of the following:

- existing licences for the intangibles (the comparables approach)
- industry norms for licenses for similar assets (the market approach)
- allocation of economic benefits derived from the use of, e.g. the patented invention (sometimes referred to as the available profits or analytical approach)
- licensing practice (rule of thumb approaches).

6.8 Licensing appraisal examines specifics such as:

- how other relevant licences were negotiated
- intangible asset and support
- length of the licence agreement
- exclusivity
- special terms for special deals
- geography
- sector in which the intangible asset is licensed
- any special relationships.

Even if previous licensing practice is comparable, it can only provide a benchmark. Intangibles, by their nature, are unique and involve carrying out numerous required adjustments to make a fair comparison.

6.9 PVT models the approaches such as the relief-from-royalty method (see paragraph 5.10).

7 Reports

7.1 Where the valuation has to comply with the Red Book, the valuer must produce a report that complies with the minimum terms set out in VS 6.1. Generally the report has a brief introductory section or executive summary that defines the assignment, summarises the conclusion and sets the stage for the details of the report. The structure should move from the general to the specific, providing a logical flow of data and analysis within which all the necessary considerations can be incorporated, leading to the valuation conclusions.

7.2 Most situations will easily form into major sections as follows, although not necessarily in this order:

- introduction
- purpose and basis of valuation
- subject of valuation
- description and history of the asset(s), and the business entity in which it has (they have) been used
- accounting and accounting polices
- financial statement analysis, if appropriate
- business and marketing plan analysis, and prospects
- search results for comparative transactions
- industry in which the asset is used
- economic environment, yields and risk assessment
- valuation methods and conclusion
- caveats, disclaimer, and limitations.

7.3 Some reports will have a separate section containing a general discussion of valuation methodology, which will often follow the introduction. If national, regional and economic data are important to the company and asset, each may have its own section.

7.4 Where appropriate, factual information, or sources thereof, should be identified either in the body of the report or in the appendices. Where the report is that of an expert required for litigation purposes, it must adhere to the requirements imposed by the local jurisdiction, for example, in the UK, the Civil Procedure Rules (CPR) Part 35, and must therefore contain all relevant disclosures including the statement of the expert's qualifications and the 'Statement of truth'.

8 Confidentiality

8.1 Information in respect of many intangible assets will be confidential. Valuers should use their best endeavours to preserve such confidentiality, including information obtained in respect of comparable assets. Where required by the client, valuers of intangible assets will comply with any requests to enter into non-disclosure or similar agreements.