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The increasing importance of brand and intangibles in industry

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Tony Hadjiloucas
Partner

tony.hadjiloucas@cy.pwc.com
Direct line: +357 25555270
Mobile: +357 99411990

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- Introduction to intangible assets
- The changing role of IP and intangibles
- Intangible asset issues faced by companies today
- Discussion

Introduction to intangible assets

Intangible assets defined

According to Valuation of Intellectual Property and Intangible Assets, Second Edition, by Gordon V. Smith and Russell L. Parr, 1994, ("Smith and Parr"), page 83:

"Intangible assets are all the elements of a business enterprise that exist in addition to working capital and tangible assets. They are the elements, after working capital and tangible assets, that make the business work and are often the primary contributors to the earning power of the enterprise. Their existence is dependent on the presence, or expectation, of earnings"

Characteristics of intangible assets

- They are capable of legal enforcement and also of legal transfer of ownership
- They are capable of producing revenues in their own right
- The assets are capable of generating additional resources / cash flows / profits over and above those which the business would otherwise make if it did not own the rights in question
- They are often separable from the underlying business
- The asset can be regarded as a capital asset rather than a carry over of recent expenditure

Why intangible assets are important

PwC research shows that total intangible assets comprise, on average, some 75% of companies' value

Intangible assets may be the only thing of significant value in the business.

This is because:

- They provide barriers to entry
- They differentiate products (even commodities)
- They provide a more stable and profitable earnings stream
- They can have a long life (e.g. brands / trademarks)
- They may provide international recognition

Recent developments signify their increasing importance: Funds and private equity firms focussed on IP, auctions, transactions, trolls, changing senior management views etc

What are Intangible Assets?

Intellectual Assets

Intellectual Property ⟷ **Intellectual Capital**

Patents	**Trademarks** **Publishing Rights** **Brand logos designs**	**Copyrights** **Information databases** **Industrial Design** **Software Platforms**	**Trade Secrets** **Confidential Information** **Technology**	**Know-How** **Customer Capital** **Unpatented research**	**Knowledge Providing Value** **Human capital**

Intangible asset issues faced by companies

Exploitation and management – IP audits

- What is our return on investment in the IP? (e.g. brand investment)
- Should we consider co-branding or a brand extension? Would this add value?
- Should we continue developing a particular piece of technology or not?
- Do we own non-core IP that we could out-license?
- Could we get more out of our core IP?
- Is our IP adequately protected and insured at an appropriate level? (patent threats, design-around risk etc)

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Transactions and licensing

- Should I sell/buy a piece of IP outright or license it?
- What is the right price/royalty rate?
- Should the licensing agreement be exclusive or non-exclusive?
- What is the correct balance between upfront fee and ongoing royalties?
- At which stage of development of a piece of IP do we sell it? What is the upside potential and downside risk?

It is likely that the IP valuation will be challenged by the **other party and its advisors**

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Disputes and litigation

- Where infringement of patents has occurred, can we measure the resulting loss in profits and/or IP value?
- In bankruptcy, who owns the licenses and the intellectual property controlled by the company going bankrupt?
- What is the appropriate standard definition of value which should be used (e.g., investment/strategic value, market value or fair value)?
- Am I receiving the royalty income I deserve? Is my licensee complying? (royalty audits)

It is likely that the IP valuation will be challenged by the **other party and its advisors (potentially in court) or by independent arbitrators**

Financial reporting – FAS 141 and IFRS 3 requirements

All companies on listed exchanges in the US and the EU are now required to perform a purchase price allocation exercise for all acquisitions of businesses, which involves the identification, valuation and recognition of intangible assets

Recognition criteria for intangibles:

"Contractual or legal right" or **"Separable from the business"**

It is presumed that fair value can be reliably measured

It is likely that the IP valuation will be challenged by the **company's auditors** and possibly also by **regulators**

Financial Reporting - Example list of intangibles from IFRS 3

Contract-based
- Service or supply contracts
- Licensing, royalty agreements
- Construction permits
- Employee contracts
- Lease agreements

Customer-related
- Contractual relationships
- Order/production backlog
- Non-contractual relationships
- Customer lists

Marketing-related
- Trademarks and tradenames (Brands)
- Non-compete agreements
- Trade dress
- Internet domain names

Technology-based
- Patented technology
- Unpatented technology
- Trade secrets
- Databases
- Computer software

Artistic related
- Musical works
- Video and audiovisual material
- Pictures, photographs
- Plays, operas and ballets

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Financial Reporting - the Purchase Price Allocation (PPA)

Step 1 — **Understand the transaction**
- Consideration of "facts and circumstances" (structure /rationale for transaction)
- Measurement of purchase price

Step 2 — **Purchase price allocation process**
- Identification of Assets and Liabilities (including self generated intangible assets within acquired business not recorded on balance sheet)
- Estimation of remaining useful lives
- Fair Value calculation of acquired tangible and intangible assets

Step 3 — **Treatment of goodwill and impact on financial statements**
- Calculation of remaining goodwill
- Review of impact on future earnings
- Consideration of impairment test procedures

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Taxation

Where IP is transferred within a group, how do we determine the appropriate disposal proceeds for tax purposes?

Can we establish the base cost of an intangible asset for the purposes of calculating a taxable gain on transfers, either within an international group or as a result of a third-party disposal?

How do we demonstrate that transfer pricing arrangements are consistent with the allocation of intangible value within the group?

How do we determine an appropriate arms-length royalty rate?

The IP valuation is likely to be challenged by the **Inland Revenue or Other tax authorities**

Lifing of intangible assets

Estimating the useful life of intangible assets

- Estimating the useful life is important in determining the value. Generally the longer the life, the more valuable the intangible asset.
- There are also accounting requirements that govern what life is ascribed and the subsequent effect on the profit statement.
- Indefinite life is allowed for accounting purposes
  - BUT beware the impairment test
- If not indefinite, then how long?
  - Requires judgement
  - Will affect earnings
- Clearly has a value impact

Useful Life Determination

- Many factors are considered in determining the useful life:

- Longevity
- Typical product life cycles for the asset
- Technical, technological, commercial, event or other types of obsolescence
- Market share - industry, demand, competitors
- Evidence of ability to adapt to changes in market conditions, investment

Consider relationship between different intangible assets, or between intangible and tangible assets (e.g. drug patents and trademarks)

Case study

- What is your estimate of the useful economic life of the following:
  - Marlboro
  - Gillette
  - Facebook

Useful Life

Indefinite life does not mean infinite life!

Finite lifetime

- Patents
- Technology
- Order Backlog
- Customer Relationships
- Most brands

Potential indefinite lifetime

- Some brands
- Some broadcasting licenses

PwC lifing research initiative

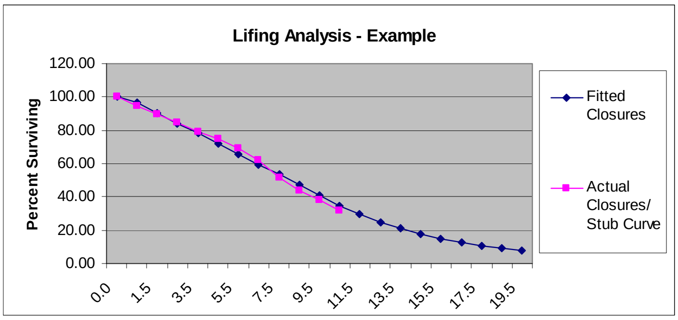
Lifing analysis

Used to model the remaining useful life of wasting assets such as customer relationships – note that useful life should include expected renewals of customer contracts

- Based on fitting actual historic attrition data against recognised statistical lifing patterns
- Enables one to build a profile of the remaining asset life based on the current age profile of the asset and its expected average useful life
- Enables you to build a time profile estimating how much of the asset will be left at the end of each year

Lifing Analysis

Example of lifing curve:



Discussion

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