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VALUATION OF INTANGIBLE ASSETS : SPECIAL REFERENCE TO NASHIK

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Abstract :

The research paper is intended to stimulate discussion of valuation of intangibles and tax benefits in the Indian parlance. The different types of valuation approaches commonly used. These approaches are: - cost approach, income approach, open market approach and relief from royalty approach. The publication entails the tax benefits and the relevant judicial pronouncement on the aspect of valuation and tax savings.

Key Words : I.P.R. Intellectual property rights, M.V.: market value. O.M.V.: open market value.

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The author view and choice of examples is his own. The author recommends you seek professional legal or technical advice where necessary and accepts no liability for any claim brought as a result of you or the third party relying on this information. This study represents examples of hypothetical practice and due to sensitive nature of valuation, may not be relied upon for any purpose whatsoever. The names of the companies and individuals are invented (the reputation and prospects of the companies are known to all) and resemble no person dead or alive. Further any such resemblance should be ignored as a mere coincidence.

When one desires to start a business one faces two options. First it to start it up by acquiring various assets oneself. Second is to buy an existing business. When the second option is exercised, a premium, over the first option, may be involved by way of consideration for work already done, for certain legal right or for some innovation attributable to past research benefits of which accrue in future. In accounting parlance it is known an in tangibles (Refer 1)

Each intangible asset is unique. Even in categories where thee are many examples, intangible assets gain value from differential efficacy from similar nature. This differential efficacy empowers the owner to exploit the valuation aspect.

User of financial statement also emphasized a need for better information about the intangible assets because those assets are an increasing economic resource for many entities and are an increasing proportion of the assets acquired in many business combinations. [F. A. S. – 141]

Intangible assets need to be reported as information about it is capable of making difference in users decision. [F. A. S. – 142]

There are various intangible assets, such as trade marks, patents, copy rights, software, database, trade secrets, know how, registered design, domain name, brand name and other.

As the paper undertakes cases of intangibles in Nashik, the applicable A.S. 26 excludes

1) Intangible assets that are covered by other standard
   (i) Computer Software can be used as an inventory item for software companies. [Covered by A.S. 2]
   (ii) Goodwill on amalgamation to be covered by A. S. 15.
   (iii) Deferred tax assets will be covered by A. S. 21.
2) Voluntory separation cost, termination benefits paid to the employee on retirement to be covered by A. S. 15.

Valuation Aspects :

The following factors must be borne in mind when identifying, describing and valuation of the asset :

- Economic life.
- Commercial life
- Legal life.
- Use of other to exploit it.
- License agreement.
- Contracts such as patents right or workforce.

As far as intangibles are concerned license agreement and contract covers the features of points covered under 1 to 4 above.

Techniques of valuation and measurement :

Relief from Royalty :

As a means to arrive at the value of intangibles, the approach chosen hypotheses the royalty that would need to be paid. The predicted royalty is taxed. The royalty judgment is based on the market value. The appropriate rate of discounting factor is judged by : -

- Appropriate rate of return.
- Risk involved.
- Risk returns relationship.
- Dynamics of the market.

Under this method all relevant cost should be accounted for. The asset should be considered debt free.

Direct Intellectual Capital Method :

Estimates the Monetary value of intangible assets by identifying its various components. Once these components are identified, they can be directly evaluated, either individually or as an aggregate coefficient.

Return on assets method :

Average pre- tax earnings of a company for a period are divided by the average tangible assets of the company. The result is than compared with the industry average. The difference is multiplied by the company's average tangibles to calculate average annual earnings from intangibles.

Rule of Thumb

This is one of the most commonly used methods. The owner of the assets may states a claim over 20 per cent to 35 per cent of the operating profit generated by the use of assets.

Case Study: I

Valuation of Patent :

Patent system is a technique to boost innovation. This is because patent, by conferring rights to the owner to exclude competition from market, offer the incentive for people to study new technology. In some field it is argued that the monopoly of patents in the market will make sure the owners recover huge expenses invested in research and development phase.

The M. J. wanted to sell its Intellectual Property Right but the confusion prevailed over its valuation.

Valuation approach chosen : - Income approach.

In the given sinerao (being a transaction) the fair market value can be used as a basis for valuation. The parameters being the market (localized, Nashik), the Main product (Domestic generators), product parameters :- the main features being the components of designs, simplicity of procedures, fewer complexity.

As income approach is chosen as the basis of valuation the Cash flows and the discount rate must be accounted for. For the purpose of cash flows relief from royalty can be used. The turnover and the associated cash flow can be worked out by the following financial modeling :-

Table No 1 Financial modeling Of Cash flows :

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Sales attributable to patents	22600	55000	101600	214000	318400	470400	625200	822400	1033400	1274000
Royalty 5 %	1130	2750	5080	10700	15920	23520	31260	41120	51670	63700
Tax (30%)	339	825	1524	3210	4776	7056	9378	12336	15501	19110
Profit after tax	791	1925	3556	7490	11144	16464	21882	28784	36169	44590

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Discount Period Years	1	2	3	4	5	6	7	8	9	10
Present value factor (25 %)	0.8	0.64	0.512	0.4096	0.3277	0.2621	0.2097	0.1678	0.13422	0.10737
Present value of cash flow	632.8	1232	1820.7	3067.9	3651.7	4315.9	4589	4829.2	4854.52	4787.81

Valuation :

As the terms of the contract stipulates the 10 years period, the projections are for 10 years. The discount rate of 25 per cent Is assumed because of expectancy from the members, the high rate of inflation and high cost of borrowing and other factors. The value of cash flows today calls for Rs. 33781

Conclusion :

Cash flows are derived from relief from royalty method. Careful assumptions about the life of the subject assets and the rate of discounts are made.

Case Study : II

Valuation of Royalty :

Cases of royalty in Nashik are analyzed from the book authors viewpoint. A prominent author of Nashik was interviewed and the following inferences were drawn:

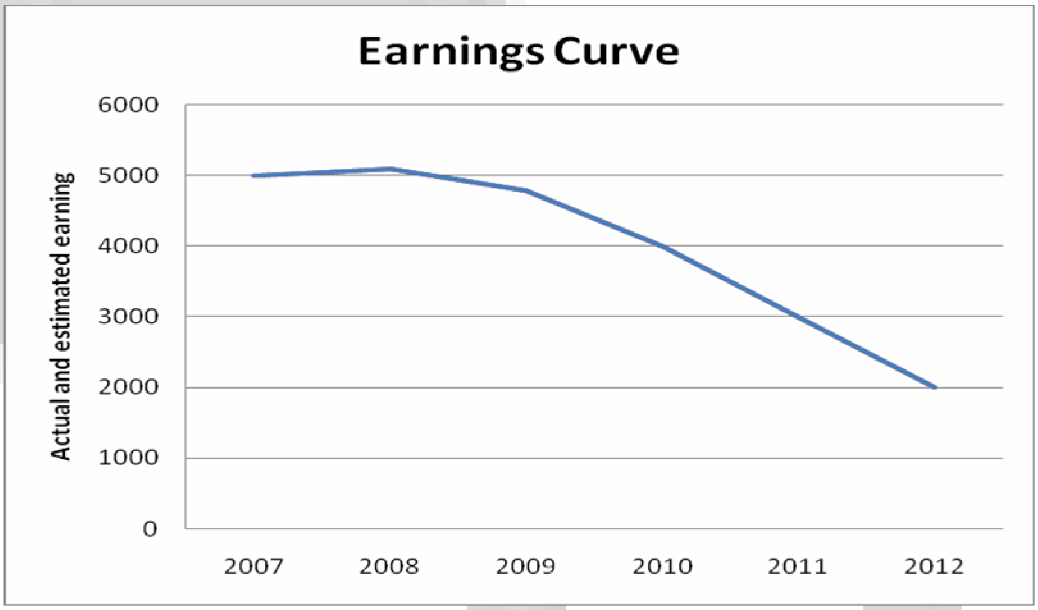
Valuation approach chosen :

Earning approach.

The past and probable future earning can be plotted on graph for the perusal of the reader. in the graphical presentation the books in print serves as a basis of the reputation enjoyed by the author and those out off print are out off question. The year of valuation being 2011. The number of books printed in the graphical representation shows:

Table No 2. Earning After All Cost and Taxes :

Year	No. of books	Earning (after cost)
2007	100	5000
2008	100	5100
2009	100	4800
2010	100	4000
2011	100	3000
2012	100	2000



It is advertently clear that the author can expect a royalty of Rs. 3000 in the year of valuation. However he can still hang on for the higher limit of Rs. 4000 the same notified facts shows the decline in the coming year to Rs. 2000. The discussion between the two showed that this value was likely to be accomplished.

Conclusion :

This being a small instance without going into much of details governing the aspect of Earning viz taxes, probability tables, present value factor, etc. the earning approach provides an easy method of analysis. The revenue streams are subject to simple market investigation.

Suggestions :

At the outset it must be noted that intangibles are eligible for depreciation under the Indian Income Tax Act 1961. The proper mode for its valuation must be resorted by valuers.

For instance the issue of eligibility to claim depreciation in respect of technical knowhow, G. C. Ltd. clearly mention that intellectual properties rends in the form of designs, drawings, manufacturing processes and technical knowhow were being transferred to the assessee company. The assessee did not have any experience in this line of business and was totally dependent on the technical know purchased by it from G. C. Ltd for manufacturing the various products. No specific value shown to the intangible assets in the Balance Sheet of G. C. Ltd, did not mean that there was no intangible assets in the form of technical know-how, drawings, designs etc., A **valuation** report was submitted. The approved valuer has valued the know-how acquired at Rs. 2.41 Crores and royalty payable for use of brand name, trademark, logo at Rs. 2.67 Crores. The parties or the authorities have not disputed the above values determined by approved valuer. The Special Bench of the Tribunal in the **case** of Amway India (supra) has held that if the software is useable/used for more than 2 years, it is a capital expenditure and if it is for less than 2 years, it is revenue expenditure. that in the present **case**, since the assessor had purchased the user of brand name, trademark, logo for 3 years and similarly, the intellectual property right such as design, drawings, manufacturing processes and technical know-how in respect of the products manufactured by unit was acquired, {further that the expenditure incurred in this regard as valued by the approved valuer) is capital expenditure on which the claimed depreciation was allowable.

Note :

While it should be clearly noted that, when in a transaction of buying an assets, there are certain rights are conferred from the ownership, it does not constitute an intangibles. Say for example a land purchased and recorded at a certain value as lease hold land does not constitute an intangibles "leasehold right” distinct from the land.

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