

# Knowing Your Value\*

Resurging M&A in Asia's Financial Services –  
Caveat Emptor!

To Buy or Not to Buy

Goodwill = Goodbuy or Goodbye?

Valuation of Intangibles

Benefits-in-kind Reaps Benefits in Tax

# Editor's Note

Mergers and acquisitions (M&A) are on the rise again, according to statistics provided by Karen Loon. Few will disagree that M&A deals make sense when they reinforce a company's existing competitive position or when they help a company make a shift as the industry's competitive base changes. Regardless of whether the deal is a merger or an acquisition, these transactions are fraught with risks and are potentially costly beyond the money paid. Yet decisions on M&A are often made without due consideration for the key risks. Karen highlights the often overlooked risks associated with a financial services industry M&A transaction. These include regulatory, governance, risk management framework and control environment.

How will FRS 103 affect acquisitions? asked Peter Low in his article *To Buy or Not to Buy*. Peter identified 4 factors for management's consideration in the context of FRS 103:

1. How do the acquired intangible assets and contingent liabilities affect the post acquisition financial position?
2. What is the financial effect of any excess of the acquirer's interest in the net fair value of acquiree's identifiable assets and liabilities over cost (negative goodwill)?
3. How good a fit is the target?

4. How would restructuring costs impact post acquisition results?

Keoy Soo Earn explains the key concepts underpinning FRS 103 in the article *Goodwill = Goodbuy or Goodbye?* He also identifies examples of intangible assets to be recognised and valued separately from goodwill and the valuation methodologies which will satisfy the rigour imposed by the standard.

Lucy Gwee takes us on a journey of discovery on intangible asset valuation. Starting with the basic – cost approach – and ending with the esoteric – probabilistic discounted cash flow. So, can an intangible asset be reliably measured? ...Read on.

Human capital, arguably the greatest source of competitive advantage, is not recognised as a separate intangible asset but subsumed in the general goodwill acquired in an M&A deal. Jenny Goh explores the tax advantages of Benefits-in-kind in keeping human capital intact without increasing operating costs. Too good to be true? Jenny argues her case in *Benefits-in-kind Reaps Benefits in Tax*.

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In July 2004, the Council on Corporate Disclosure and Governance (CCDG) issued FRS 103 *Business Combinations*, which is effective for annual periods beginning on or after 1 July 2004.

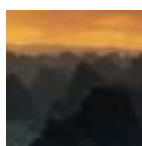


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Following the recent introduction of Financial Reporting Standards (FRS) 103 *Business Combinations* coupled with the revised FRS 36 (2004) *Impairment of Assets* and FRS 38 (2004) *Intangible Assets*, companies are required to comply with these requirements when accounting for business combinations for annual periods commencing on or after 1<sup>st</sup> July 2004...



### Valuation of Intangibles

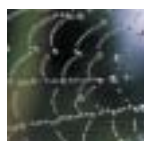
FRS 38 defines an 'intangible asset' as 'an identifiable non-monetary asset without physical substance'. Intangible assets include intellectual property such as patents, trademarks, copyrights, trade secrets and industrial know-how as well as customer lists, software license, franchise agreements, trained workforce, networks, etc. These assets are rapidly becoming a core source of wealth creation in many sectors of the economy...



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BY KAREN LOON Banking and Capital Markets Industry Group

## Resurging M&A in Asia's financial services industry – Caveat Emptor!

A rise in business confidence has seen an increase in the level of restructuring activity in the financial services industry over the past twelve months in a number of Asia Pacific countries, including China, Indonesia and Japan. The increasing importance of other stakeholders, and their expectations, means that financial institutions can no longer focus solely on obtaining acceptable shareholder returns when entering into transactions. Prior to determining whether they should enter into a transaction, financial institutions need to ensure that appropriate consideration is given to the needs and expectations of shareholders and other stakeholders and build in appropriate commercial due diligence procedures into the deal process to take into account these expectations.

## A new wave of restructuring in financial services

2004 has seen an increase in the level of merger and acquisition (M&A) activity in the Asia Pacific region as a whole, especially in the financial services industry, including countries like China, Korea, Indonesia and Japan.

	Announced Value (US\$ million)	Number of Deals
2000	168,099	544
2001	270,096	605
2002	91,765	478
2003	101,822	497
2004 (up to Q3 2004)	172,261	375

Figure 1: Annual volumes of cross-border banking M&A transactions

Source: Bloomberg

However, this wave of restructuring activity will be different from the blockbuster transactions in the 1990s as:

- Regulators are exercising greater influence
- Competition is intensifying
- Awareness of the challenges and pitfalls of undertaking mergers and acquisitions is high
- The seeds of economic recovery remain fragile
- Institutions are more wary than ever of reputational and others forms of risk

Almost four out of five financial services respondents to an online survey conducted in September and October 2003 by PricewaterhouseCoopers and the Economic Intelligence Unit (EIU) expect their firms to be restructured significantly within the next five years. 92% believed that restructuring will be 'important, very important or integral' to help complete their strategies. 64% and 53% of survey respondents cited regulatory capital and reporting requirements as the most likely issues to impact on their firms' strategy for restructuring.

The next wave of restructuring is likely to be characterised by:

### Innovation

- Straightforward M&As may not be the way ahead
- Alternatives in alliances, joint ventures and outsourcing

### Focus

- Billion dollar deals, but...
- Blockbuster mergers of big institutions less likely
- Restructuring is likely to be realistic rather than radical

Much of this activity, which will be designed to sharpen focus, improve efficiency and take incremental steps forward, is being driven principally by external drivers including increasing competition and customer demands, as well as regulator restrictions (refer to Figure 2).

What will be the main external drivers of your organisation's restructuring activity over the next five years?  
Please choose up to three answers.

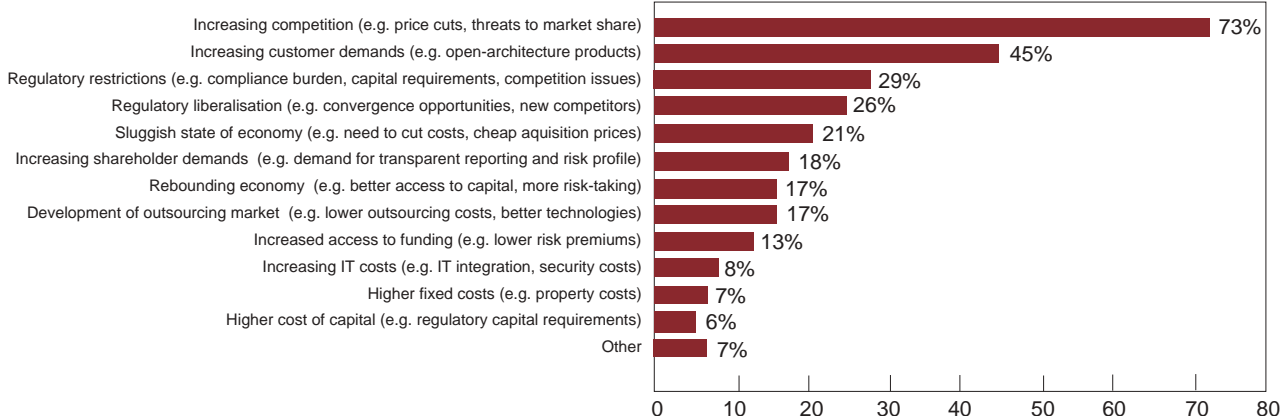


Figure 2: Drivers of restructuring activity

Source: PricewaterhouseCoopers/Economic Intelligence Unit survey, September - October 2003

The briefing also revealed that many financial institutions will no longer seek to be in every segment and territory in which they operate. Instead, they will look to expand regionally instead of expanding globally or focussing on niche products and services, especially in insurance, asset management and alternative investments. Asia will be increasingly on the radar screen of many institutions – one third of North American respondents and 40% of Western European respondents have set sights on Asia as an important target for acquisition activity.

It is also interesting to note that outsourcing is no longer regarded as a way to cut costs but as a logical result of the need by financial services firms to stick to what they do best. One of the drivers of changes and innovative thinking – especially in Asia – has been the costs associated with implementing various regulatory and reporting changes. This has encouraged banks to look to new ways to do things. In Asia, there are many examples of banks moving in this direction, such as HSBC's decision to transfer a further 4,000 jobs from Britain to the bank's existing processing centres in India, China and Malaysia. Others have been increasingly looking to use outsource specialists, in particular specialists from India as they have now raised their game: presently, they do everything from writing programs to installing enterprise software and monitoring computer systems from afar, as well as performing voice and text messaging services, producing investment banking 'pitch' documents, and other higher value-added services.

### Caveat emptor – Buyer beware!

Financial institutions often enter into transactions based primarily on strategic fit, and select targets that score high on both competitive strength and compatibility with the acquirer. Due diligence exercises for many M&As, joint ventures, alliance and outsourcing transactions are often focussed on whether the expected shareholder returns from the transaction will be acceptable. The deadline-driven pressures of completing a transaction often means non-financial issues are overlooked or given inadequate attention at the pre-deal stage.

Financial services transactions are also getting more complicated; whilst there have been a number of large in-market financial services transactions in the last two years, the proportion

of cross-border financial services deals has been increasing. In-market transactions tend to be lower risk, as the primary drivers are costs and revenue synergies, which can be more easily estimated in advance. Flawless execution is still critical, although admittedly there are less risks in relation to the deal valuation. On the other hand, in spite of the higher execution risk faced, financial institutions need to continually look to cross-border transactions to develop new market places and diversify risk. On the valuation side, it is more difficult to produce synergies from collaborative efforts of international operations. As such, any premium paid over and above the fair value of the business on a standalone basis must be justified by something extra which the acquirer brings to the table – whether it is better management, clearer strategy, access to new products or better systems – which often tends to be hard to value accurately. Due to the added complication of managing both corporate and ethnic cultural differences, this makes it more challenging for an organisation to execute and integrate a cross-border operation and subsequently realise the expected synergies.

As such, transactions are facing more scrutiny today than they were a few years ago. Several studies covering M&A activity in the past 75 years have concluded that well over half of mergers and acquisitions failed to create their expected value. Ironically, in many cases, value was destroyed and the company's performance after the deal was significantly below what it had been before the deal. Often, this may have been due to the acquirers paying more than the acquisition was worth to them<sup>1</sup>. With the knowledge gleaned from such experiences, financial institutions are under pressure to execute transactions more effectively in order to further their strategic objectives. In this environment, a thorough target screening process is essential.

Financial services cross-border transactions are becoming increasingly more complex as regulatory and other stakeholder expectations change, and regulations become more complex. As financial institutions look toward opportunities in new markets and products, due diligence procedures need to increasingly focus on non-financial areas which could impact the ability of a financial institution to minimise its closing and integration risk. Commercial due diligence areas which require focus include regulatory risk, human resources, governance, risk management and control environment, and differences in accounting standards. Inadequate consideration of these

<sup>1</sup> Eccles, R.G., Lanes, K.L., and Wilson, T.C., 'Are You Paying Too Much For That Acquisition?', Harvard Business Review, July/August 1999, Vol.77, Issue 4. Kersyen L.Lanes is a partner of PricewaterhouseCoopers in New York.

areas may inevitably result in delays in implementation and sometimes the full potential of the transaction may not be achieved. This could expose the institution to greater reputational risk and potential brand erosion.

### Are regulatory risks fully understood?

Not only do financial institutions need to manage their shareholders, they also need to manage other critical and important stakeholders, including employees, customers, regulators, rating agencies and the government (refer to Figure 3).

Our PricewaterhouseCoopers/EIU Financial Services briefing *Governance: From compliance to strategic advantage*, issued in April 2004, noted that over 50% of Asian respondents indicated that boards, regulators and management have gained influence over the strategic decision-making of financial institutions as a result of greater focus on governance.

Compliance with government and exchange-mandated rules is often seen to be less important for avoiding reputational risk than internal codes of practice, according to a

PricewaterhouseCoopers/EIU Financial Services briefing issued in June 2003 on *Compliance: A gap at the heart of risk management*. Adherence to the law is necessary, but by no means sufficient, to protect against reputational risk. What's more, due to the importance and complexity of products, the burden on financial services institutions to ensure that all reasonable steps are taken to protect consumer rights is much more onerous than in other industries. Due diligence procedures should include consideration of both the target's compliance with mandated rules, as well as the strength of its compliance framework, policies and internal codes of practice.

Managing regulatory risk will be one of the key drivers for success of financial institutions over the coming years in determining everything from capital to reporting processes. Winners will seek to understand the current and future regulatory environment and undertake to embed a culture of compliance throughout their organisation. They will also build close relationships with the regulators.

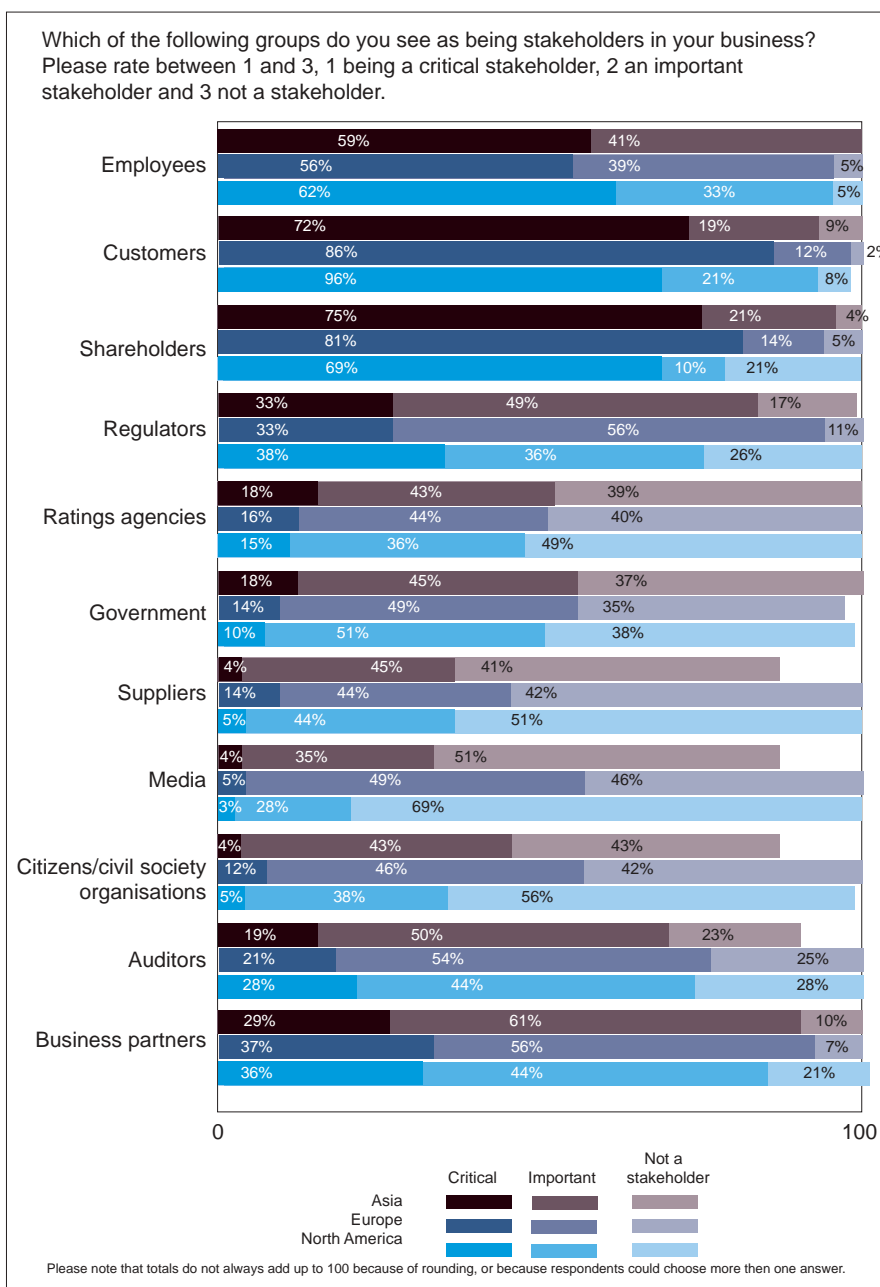


Figure 3: Key stakeholders  
Source: PricewaterhouseCoopers/Economic Intelligence Unit survey, October 2004

## Regulatory risks to watch out for:

- What is the relationship between the target and its key regulator?
- Have you had dealings with the target's regulators?
- What is the relationship between your home regulator and the target's regulator?
- Does the target have a 'compliance culture'? What is the quality of the compliance department's staff? Is compliance given appropriate prominence in the organisation? How is compliance risk managed – is it proactive or reactive?
- Code of Conduct and management's ethics – Does the organisation have a code of conduct, and how does it enforce compliance? Have we considered the ethics of management?
- What is the quality of the target's regulatory reporting to the regulator? How robust are their reporting processes, and are they reconciled to the financial statements? Will they be able to report sufficiently accurate and timely data to the acquiring entity to facilitate reporting to your home regulator?
- How robust are the target's capital computation processes? Will the target be required to comply with Basel II requirements locally, and when?

## Do we fully understand the 'people issues'?

As financial institutions continue to extend their reach into overseas markets, their human capital strategies should increasingly focus on human resource (HR) due diligence and post-merger integration issues. Focussed up-front research, combined with careful planning is essential to ensure a quick and effective transition once the transaction has been completed.

Financial institutions should undertake a careful assessment of people issues during the due diligence process. Looming deadline pressures often means that critical people issues are skipped or skimmed over at the pre-deal stage. Many M&A transactions fail to deliver anticipated increases in shareholder value, because 'people issues' are not addressed effectively or quickly enough.

## People issues to watch out for:

- **Governance**  
Consider early in the process whether to run the target as an independent unit or part of an existing business
- **Determine the people you want**  
Retention programmes should be linked to integration goals, and should consider relative criticality, period of retention, the target's change in control payments, award size, funding of packages, time-base of payments and back-loading of payments
- **Find and consider resolution of cultural differences**  
Cultural fit should be assessed early in the due diligence process, and include organisational form (centralised vs. decentralised), business horizon (long term vs. short term), and leadership style (autocratic vs. decentralised). The cultures of the target and acquiring entity should be mapped to identify differences in operating styles, cultural drivers and HR policies

## Is the governance, risk management framework and control environment appropriate?

Whilst the impact of new legislation like the Sarbanes-Oxley Act in the United States and the Basel Committee guidelines is resulting in some convergence of views on governance, risk management and control of financial institutions globally, the strength of the governance and control environments of financial institutions in many jurisdictions do differ significantly, often as a reflection of the sophistication of the financial markets, as well as the regulatory and cultural influences in that jurisdiction. An acquirer should pay close attention to the quality of the governance, risk management and control environment of the target, including unique local business practices that the acquirer may not wish to permit after acquisition. In some cases, changes in the policies in relation to acceptable business practices could impact the future profitability of the acquired entity.

As part of the due diligence process, an acquirer should also consider how it intends to oversee and integrate the operations of the acquiree. Recent large losses due to lapses in control environments in subsidiary banks and overseas branches have

continued to highlight the importance of ensuring that an appropriate governance risk framework governing overseas operations is in place. Home regulators expect an appropriate governance, risk management and control framework to be exercised over all operations of a regulated group, and may have an expectation that the acquiree's control environment will operate at a level acceptable to the home regulator soon after acquisition.

### Governance, risk management and controls to watch out for:

- **Key Performance Indicators and MIS**

Are these sufficiently robust and accurate to allow monitoring of key performance indicators of the organisation? Are they available on a timely basis?

- **Escalation procedures**

Are control exceptions and other issues escalated to senior management on a timely basis, and are procedures for escalation defined?

- **Control Self Assessment (CSA)**

Does the organisation use CSA or other tools? Are the results of the CSA objective?

- **Internal audit**

Who does the Head of Internal Audit report to? What are the qualifications of the internal auditors and do they follow the COSO framework or equivalent? Is their approach and are their report gradings sufficiently risk-focussed? Do they review all areas of the financial institution, and does the timing of their visits appropriately reflect the risk of the business area? Are control exceptions escalated to the Audit Committee/senior management on a timely basis, and appropriate follow-up actions taken on a timely basis?

- **Financial controls**

Does the institution have in place a General Ledger Reconciliation process, or even a certification process over its financial numbers and is it robust? Are controls over intercompany, inter-entity, inter-unit, suspense, clearing accounts tight and reconciled on a timely basis?

- **Support units**

Is appropriate investment given to support units to allow them to support businesses appropriately? What investment will be

required to upgrade the support unit systems, people and processes to an appropriate standard? If we are likely to process or book transactions in another country, have we thought through the regulatory (including client confidentiality and taxation) issues?

### Have we understood differences in accounting standards?

Whilst accounting standards globally continue to converge, and will continue to change rapidly, nevertheless differences in standards and their application do exist. Some countries in Asia Pacific will be moving towards full compliance with IFRS in 2005; other countries will move towards full compliance at a slower speed. In cross-border due diligences, one needs to carefully review differences in accounting standards and their local application as compared to those applied by the acquirer. This is important as it could have significant implications on the reported group consolidated numbers, as well as the appropriate consolidated capital treatment.

As part of the due diligence process, an acquirer should also consider how it intends to consolidate the results of the target, including the ability of the target's finance team to meet the acquirer's reporting deadlines and responsibilities in accordance with the acquirer's generally accepted accounting policies.

### Accounting Standards to watch out for:

- Special purpose entities, securitisation transactions, leasing arrangements, equity investments
- Differences in loan grading and provisioning regulatory standards between the target and the acquiring entity
- Classification of securities into trading, held-to-maturity and available-for-sale portfolios, and the application of appropriate valuation policies
- Purchase price accounting, treatment of deal costs and goodwill
- Classification of financing instruments as debt or equity
- Employee compensation benefits
- Possible implications of Sarbanes-Oxley Act requirements, such as Section 404

Take time to apply these five principles in assessing the true value of M&A targets.... before the next wave of M&A activity sweeps you off your feet!

### Taking the next steps

Successful restructurings over the next five years will rely on five key principles:

- (1) Defining a clear strategy
- (2) Effective communication, both within and outside the organisation
- (3) Managing regulatory risk
- (4) Differentiation
- (5) Innovation

Before entering into a transaction, a financial institution should ensure that its deal process, including its due diligence coverage, is sufficient for it to undertake a robust initial evaluation of the target before determining whether it should incur the 'heavy expenditure', and to minimise closing and integration risk. In addition to financial due diligence, commercial due diligence areas which should be appropriately covered include regulatory risk, human resources, governance, risk management and internal controls, and accounting standard differences.

Take time to apply these five principles in assessing the true value of M&A targets.... before the next wave of M&A activity sweeps you off your feet!

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BY Peter Low Professional Standards Group

## To Buy or Not to Buy?

### – How will FRS 103 affect acquisitions?

In July 2004, the Council on Corporate Disclosure and Governance (CCDG) issued FRS 103 *Business Combinations*, which is effective for annual periods beginning on or after 1 July 2004.

FRS 103 has been the cause of much debate in the Singapore business community and has made the accounting for business combinations a boardroom issue. FRS 103 requires all business combinations that fall within its scope to be accounted for using the purchase method of accounting. The pooling of interest method is now prohibited. It should be noted that the pooling of interest method is also prohibited in Australia, Canada and the United States. This alignment would result in increased comparability of financial information that will provide the market players greater insight in relation to the acquired entity. Senior management, therefore, must understand the implications of FRS 103 and be prepared to explain precisely what has been acquired and how the acquisition was transacted.

How will FRS 103 affect an entity's acquisition strategies? This article highlights some of the key issues that management should consider at the four stages of the acquisition process namely, planning, assessing, execution and post-acquisition.<sup>1</sup>

### Planning for acquisitions

FRS 22 *Business Combinations* (superseded by FRS 103 with effect from financial period commencing 1 July 2004), para 13, recognised situations whereby it may not be possible to identify an acquirer and consequently allowed the pooling of interest method to account for the merger under certain strict conditions. However, FRS 103 prohibits the pooling of interest method and prescribes the purchase method of accounting for all business combinations (para 14). It is now critical at the planning stage to identify the acquirer for the implementation of the purchase method. Where a new company is created to acquire two or more pre-existing companies, one of the pre-existing companies must be designated as the acquirer. The determination of the accounting acquirer is based on the facts and circumstances of the deal and will have a significant impact on the post-acquisition balance sheet. However, this may not always be clear especially in a complex transaction.

Under the pooling of interest method, the financial statement items are combined at cost, while the purchase method mandates fair valuing of financial statements items of the acquiree. As such, management should also evaluate the composition of the opening balance sheet as well as impact of the new rules on key ratios.

Given the financial impact of the acquisition and the additional disclosures resulting from FRS 103, it is important to plan early communication to stakeholders and ascertain adequate resources are available to ensure compliance with FRS 103. In particular, specialist resources may be required to identify and fair value intangible assets and contingent liabilities which were previously not required under the pooling of interest method.

### Assessing the acquisitions

FRS 103 prohibits the amortisation of goodwill acquired in a business combination and instead requires the goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be

impaired, in accordance with FRS 36 *Impairment of Assets* [FRS 103, IN 7(g)].

Goodwill arises when the cost of the combination exceeds the net fair value of identifiable assets, liabilities and contingent liabilities. Under such circumstances, FRS 103 first requires goodwill to be recognised as an asset (FRS 103.51).

On the other hand, when the fair value of identifiable assets, liabilities and contingent liabilities exceeds the cost of the combination (previously known as negative goodwill and referred to as 'excess of fair value over cost of business combination' for the purpose of this article), FRS 103 requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities; and the measurement of the cost of the business combination. Subsequent to the reassessment, any 'excess of the fair value over the cost of the combination' must be recognised in the post-acquisition income statement by the acquirer.

Given the above process to account for any difference between the fair value and cost of business combination, it is necessary to consider:

- How acquired intangible assets and contingent liabilities affect post-acquisition financial position;
- The financial effect of any excess of the fair value of identifiable assets, liabilities and contingent liabilities; and
- How the target fits into the organisation.

Furthermore, restructuring costs are now specifically excluded in FRS 103 and its impact should also be taken into careful consideration. The four factors for management's consideration are:

#### Factor 1:

Consider how acquired intangible assets and contingent liabilities affect the post-acquisition financial position

A fair valuation process encompasses a detailed evaluation of the potential assets and liabilities (including all intangible assets and contingent liabilities), which is required to determine the impact on the post-acquisition group balance sheet as well as income statement. This complex and rigorous valuation may require specialist

<sup>1</sup> This article is based on the PricewaterhouseCoopers, April 2004, publication *Acquisitions: Accounting and Transparency under IFRS 3*.

involvement, which will inadvertently increase the cost of acquisition.

Many of those intangible assets that would previously be subsumed within goodwill must now be separately identified and valued. By definition, an asset is identifiable when it either arises from contractual or other legal rights, or is separable. An asset is separable if it could be sold on its own or with other assets. This will capture more intangible assets than what had typically been previously recognised.

While goodwill amortisation is prohibited, amortisation charges may still increase as a result of the recognition of these identifiable intangible assets because most of such assets are likely to have a much shorter useful life than the 20 year period commonly used for goodwill.

On the flip side, companies will need to consider the impact of contingent liabilities in any acquisition transaction. Contingent liabilities of the acquired entity will be more visible as they must be recognised in the balance sheet at fair value. The existence of contingent liabilities had historically been implicitly reflected in a lower stock trading price, a reflection of the risk that such liabilities could crystallise.

### Factor 2:

Consider the financial effect of any excess of acquirer's interest in the net fair value of acquiree's identifiable assets and liabilities over cost (previously known as negative goodwill)

An excess of the net fair value over the cost of business combination could imply:

- (i) errors in measuring the fair value of the cost of the combination or the acquiree's identified assets, liabilities or contingent liabilities [FRS 103.57(a)];
- (ii) identifiable net assets not measured at fair value [FRS103.57(b)]; or
- (iii) a bargain purchase [FRS103.57(c)].

Previously, in FRS 22, negative goodwill was generally carried on the balance sheet and recognised as income on a systematic basis, whereas, FRS 103 is sceptical that bargains exist. The prescribed accounting treatment in FRS 103 strips out the earnings cushioning-effect, thus increasing the risk of later impairment if the acquisition does not turn out to be a bargain after all.

The requirement to recognise the excess immediately as a profit or loss may have an impact on the post-acquisition results if future losses and expenses arise. However, this excess should rarely remain if the valuations inherent in the accounting for a business combination are properly performed, identified and recognised. Therefore, when such an excess exists, the acquirer should perform rigorous reassessment of the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities as well as the measurement of the cost of the business combination to ascertain that such a gain truly exists.

### Factor 3:

Consider how the target fits into the organisation

A cash generating unit (CGU) comprises identifiable assets, liabilities and goodwill. Goodwill impairment is assessed within the CGU. Management should consider how the target fits into the organisation. This exercise also enables management to identify CGUs within the potential combined organisation.

This increases the risk of there being an impairment charge against goodwill – as poorly performing units can no longer be 'supported' by those that are performing well. Therefore, it is crucial that the structure of CGUs must be carefully planned to reduce the risk of impairment because poor definitions of CGUs might result in an impairment charge. It is noteworthy that the opportunities to minimise risks of future impairment are only available at the time of the transaction.

### Factor 4:

Consider the impact of restructuring cost on post-acquisition results

Previously, companies tend to include restructuring provisions in the allocated cost of an acquisition and this helps to shelter some of the cost impact of absorbing the acquired entity. Frequently, the most visible income statement effect has been positive when provisions turn out to be overstated and the excess is released to the income statement.

Restructuring provisions are now excluded from acquisition accounting under FRS 103 unless the target was already committed to the plan prior to the acquisition. All restructuring costs will be a charge in the post-acquisition income statement, making it harder to demonstrate that any

acquisition serves to immediately enhance earnings.

### Execution process of acquisition transaction

The previous sections outline the requirements to:

- (i) identify an acquirer at the planning stage; and
- (ii) consider the financial impact of the potential acquisition at the assessment stage.

Once these factors have been deliberated, an appropriate structure should be planned for consideration to execute the acquisition transaction. The purchase accounting implications of involving the variable share prices in non-cash deals which arise should also be taken into account.

The communication strategy for informing the market has to be carefully formulated to manage the financial statement impact arising from FRS 103. Organisations should recognise the need to prepare the market for any anticipated dilutions in earnings as a result of new intangible assets identified in the new transactions – which may result in more amortisation in the future – combined with the impact of new treatments for restructuring costs and ‘the excess of fair value over cost of business combinations’.

Disclosures are intended to allow users to assess the reasonableness of management’s decisions and assessment. However, in light of the increased transparency of disclosure, analysts, shareholders and other users of the financial statements will have access to more information about the nature and consequences of management decisions on acquisition than before. Thus, senior management should be prepared to handle the more informed group of analysts and other parties as a result of the significantly expanded disclosure requirements.

### Post-acquisition transaction

In FRS 103, the annual disclosures required on goodwill impairment review are detailed and onerous. At the outset, details for the acquisition cost and the financial implications, i.e. goodwill or ‘excess of fair value over cost of business combination’, are required to be disclosed. Post-acquisition, management should be aware of the requirements for impairment reviews of goodwill as well as intangible assets with indefinite useful

lives and consider the impact of those reviews. There is also a need to ensure that the market is also prepared for any anticipated impairment charges. With the impairment charges, earnings could be more volatile and unpredictable. Therefore, it is crucial to prepare the market for any (expected) volatility of the earnings as a result of implementation of FRS 103.

### Next steps

It is important to remember that these changes in the accounting treatments under FRS 103 do not affect the cash flow of the acquisition transaction. However, we must recognise that these changes may have an adverse effect on companies’ performances if the measurements are based on earnings per share due to the additional charges in the income statement.

In the light of increased risks and complexity of FRS 103, we encourage senior management to assess all potential acquisition transactions to achieve their business, economic and accounting goals.

It should also be of interest that FRS 103 encompasses phase I of the business combinations project embarked by the International Accounting Standards Board. Phase II of the business combinations project is currently being discussed by the Board and the following issues are being considered:

- rename ‘purchase method’ to ‘acquisition method’;
- definition of a business;
- deferred tax; and
- operating leases.

It is expected that revisions to FRS 103, incorporating issues arising from Phase II of the business combinations project, should be forthcoming in 2005.

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## Some key issues management should consider at each stage of the acquisition process

	Structure	Evaluation	Communications	Impacts
Planning	<ul style="list-style-type: none"> <li>Identify which party is the acquirer; this may not be obvious in a complex transaction</li> </ul>	<ul style="list-style-type: none"> <li>Consider the composition of the opening balance sheet and impact of new rules on key ratios</li> </ul>	<ul style="list-style-type: none"> <li>Early identification of the key issues is vital and requires an understanding of the accounting and disclosure requirements</li> </ul>	<ul style="list-style-type: none"> <li>Determine the likely complexity of the purchase accounting</li> <li>Plan early communication to stakeholders on the likely financial impact of the transaction</li> <li>Identify additional resources needed to comply with recognition, valuation and disclosure requirements</li> </ul>
Assessing	<ul style="list-style-type: none"> <li>Consider how the target fits into the organisation</li> <li>Which part of the business might be at risk from impairment?</li> </ul>	<ul style="list-style-type: none"> <li>Identify and value all intangible assets and contingent liabilities of the target</li> <li>Carry out detailed analysis of all potential assets and liabilities (including those above) to determine impact on the group balance sheet and income statement post-acquisition</li> </ul>	<ul style="list-style-type: none"> <li>Stakeholder communications must clarify impact of FRS 103 on particular aspects of the deal, e.g. profit impact of intangible asset amortisation</li> </ul>	<ul style="list-style-type: none"> <li>Poor definition of CGUs might result in an impairment charge</li> <li>Make good use of opportunities (only available at the time of the transaction) to minimise the risks of future impairment</li> <li>Carry out more detailed due diligence to comply with recognition and disclosure requirements</li> <li>Assess risk of impairment charges</li> </ul>
Closing	<ul style="list-style-type: none"> <li>Plan an appropriate structure for consideration</li> </ul>	<ul style="list-style-type: none"> <li>Consider purchase accounting implications of variable share prices in non-cash deals</li> </ul>	<ul style="list-style-type: none"> <li>Formulate communications strategy for informing the market in the light of increased transparency of disclosure</li> <li>Prepare senior management for more searching questions that may be raised by analysts and others</li> <li>Prepare market for any anticipated earnings dilution</li> </ul>	<ul style="list-style-type: none"> <li>The estimated value of all contingent consideration is included in the cost of the acquisition and allocated over the assets and liabilities acquired</li> </ul>
Post-deal		<ul style="list-style-type: none"> <li>Consider impact of impairment reviews of goodwill and intangible assets with indefinite useful lives</li> </ul>	<ul style="list-style-type: none"> <li>Prepare market for anticipated impairment charges</li> </ul>	<ul style="list-style-type: none"> <li>Impairment charges create earnings volatility</li> </ul>

Source: PricewaterhouseCoopers, April 2004, *Acquisitions: Accounting and transparency under IFRS 3*

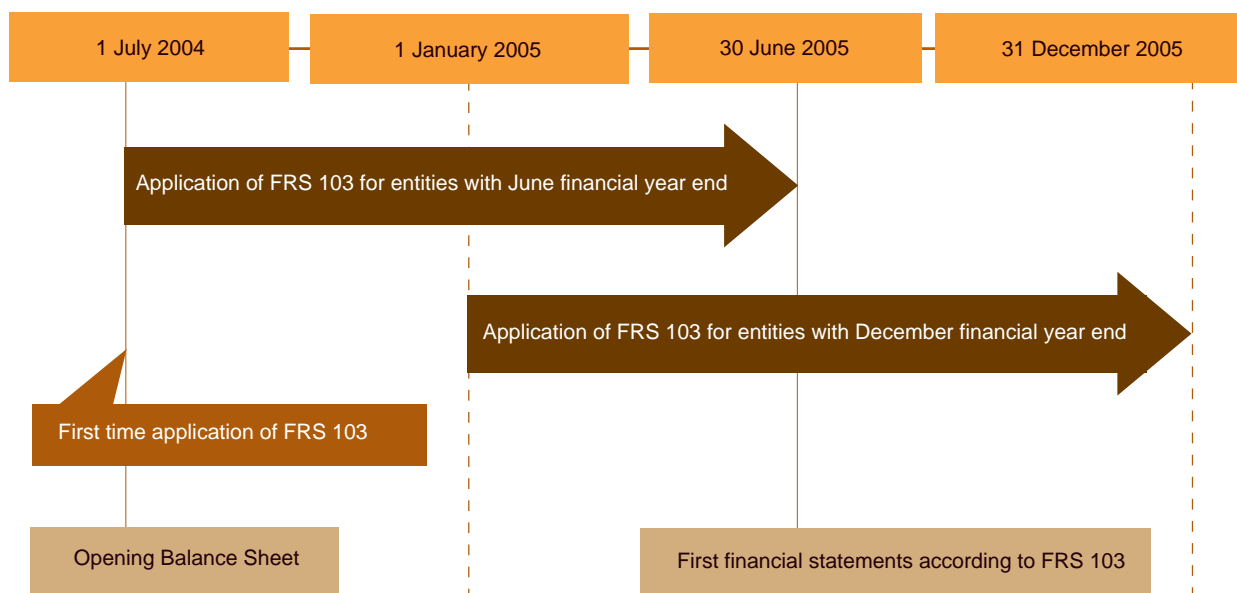


BY KEYO SOO EARN Transactions – Valuation & Strategy

## Goodwill = Goodbuy or Goodbye?

Following the recent introduction of Financial Reporting Standards (FRS) 103 *Business Combinations* coupled with the revised FRS 36 (2004) *Impairment of Assets* and FRS 38 (2004) *Intangible Assets*, companies are required to comply with these requirements when accounting for business combinations for annual periods commencing on or after 1<sup>st</sup> July 2004.

## Effective date of implementation



### Impact of the news standards at a glance

- All business combinations are acquisitions
- An acquirer must be identified for every combination
- More intangible assets will be identified and recognised on acquisition – some will be intangible assets with indefinite useful lives
- Goodwill is not amortised but subject to an annual impairment test
- Negative goodwill is recognised immediately in income
- Restructuring costs are charged to income
- Contingent liabilities are recognised at fair value
- Detailed disclosures about transactions and impairment testing are required

### Key implications of FRS 103

FRS 103 requires the purchase price of acquisitions to be allocated across all identifiable assets (separately from goodwill), as well as recognise the liabilities and contingent liabilities assumed. Accordingly, with the requirement to justify the remaining amount allocated to goodwill, it will prove increasingly more difficult to demonstrate value in the form of goodwill. In this respect, companies will have to undertake a more rigorous analysis of the goodwill amount that is stated, or to be stated in their financial statements.

FRS 103 also prescribes that goodwill no longer needs to be amortised. Instead, it will be subjected to annual impairment tests and ad-hoc testings whenever there are indications of impairment. This is likely to result in irreversible impairment charges on poor-performing acquisitions at a very early stage. Thus, it is apparent that the application of the new standard will give a more immediate indication of whether companies have overpaid for their acquisitions. One can then tell if goodwill is reflective of a good buy. With this in mind, it is important for acquirers to carry out more stringent evaluations of target firms in the acquisition process. Thorough evaluations will also ensure that the deal is able to withstand greater market scrutiny.

The new standard also means that structuring deals as 'pooling of interests' will no longer be allowed. In practice, although it has been difficult

to qualify for merger accounting due to the strict qualifying criteria, the benefits of merger accounting however, have provided companies an incentive to structure deals to meet the qualifying criteria wherever possible. Under the new requirements, an acquirer must be identified and thus companies may want to carefully consider which party will be the acquirer in complex transactions.

### Concept of Fair Value

Fair value as defined in FRS 103 is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's length transaction. The concept of fair value is a fundamental underlying principle in FRS 103 and is key to the purchase price allocation process.

### Purchase Price Allocation

Purchase price allocation has not changed radically but has been made more rigorous by the new standards. All intangible assets of the acquired business that are identifiable and separable must be recorded at their fair values. This means that any intangible asset that would have been subsumed within goodwill previously must be separately identified and valued.

Explicit guidance is provided for the recognition of such intangible assets; clarification is also made to categorise an asset as identifiable when it arises from contractual or other legal rights, or is deemed separable. An asset is considered separable if it could be sold, either on its own or bundled with other assets.

The new requirements will result in the recognition of many more intangible assets than previously. These are set out in FRS 38 (2004) and FRS 103 which prescribe the recognition of identifiable intangible assets separately from goodwill.

**Purchase price allocation has not changed radically but has been made more rigorous by the new standards.**

### Examples of intangible assets to be recognised and valued separately from goodwill

#### Marketing-related

- Trademarks, trade names, service marks, collective marks, certification marks, internet domain names, trade dress, newspaper mastheads, non-competition agreements

#### Customer-related

- Customer lists, order or production backlog, customer contracts and related relationships, non-contractual customer relationships

#### Artistic-related

- Copyrights, plays, operas, ballets, books, magazines, newspapers, musical works, pictures, photographs, videos, films, television programmes

#### Contract-based

- Licensing, royalty and standstill agreements, contracts for advertising, construction, management, service or supply, lease agreements, construction permits, franchise agreements, operating and broadcasting rights, rights to water, air, mineral, timber cutting and route authority, servicing contracts, 'favourable' employment contracts

#### Technology-based

- Patented and non-patented technology, computer software, databases, trade secrets, special formula, processes or recipes

### Challenges of identifying and fair valuing intangible assets

Along with the need to recognise intangible assets, their identification becomes a pertinent issue – and a challenging one – as it involves the attribution of the value drivers of a business to specific intangible assets. For instance, it is difficult to distinguish and quantify profit contributions attributable to a company's brand and those attributable to its strong customer relationship.

In addition, the useful life of such an intangible asset is difficult to determine as renewal periods can be taken into account under specific circumstances. This may result in the useful life deviating from the contractual duration of the customer relationship.

This is precisely where a valuation expert's experience and insights matters and makes a difference. The ability to use industry knowledge to identify the factor, of which the success of the business depends on, is of critical importance for the accurate identification of the business' intangible assets. Accurate identification lays the foundation for the accurate attribution of an intangible asset's profit contribution.

All assets acquired and liabilities, including contingent liabilities assumed, have to be recognised at fair value. This can be a complex and time-consuming process and expert valuation assistance can be enlisted to assist management in establishing their fair values and to ensure compliance with FRS 103. There are various methods to ascertain fair value; the most appropriate of which to apply requires an evaluation of the business and its circumstances.

Furthermore, as the valuation of intangible assets tends to attract some degree of scepticism and reservation, an independent expert report on the valuation of intangible assets will lend credibility to the assessment. It is advisable to seek an expert valuer who is familiar with generally accepted accounting principles and the requirements of FRS 103. Otherwise, companies may find themselves having to justify and reconcile the treatment with auditors who are required to attest to the values stated on the financial statements.

**...an independent expert report on the valuation of intangible assets will lend credibility to the assessment.**

## Common valuation approaches

The 'market' approach is based on a premise that prices paid for comparable intangible assets in current or prior transactions can serve as a guide in the valuation of the subject asset. While this is a reliable estimate of the fair value of an intangible asset, due to the uniqueness of many intangible assets acquired and the lack of information about prior transactions, the application of the market approach is often limited.

The income approach is most commonly used in the valuation of intangible assets. This method estimates the fair value of an intangible asset through the calculation of the present value of economic benefits that it is expected to generate. The challenge in using this approach lies in the ability to identify and project the expected cash flows attributable to the asset, the determination of an appropriate discount rate, and the determination of the remaining useful life of the asset.

The cost approach is relatively intuitive in application, as it is based on the premise that a buyer would pay no more than the amount for which it would cost to reproduce the asset. Using this method, the valuer must consider all costs that would be incurred to replicate the asset, such as materials, labour, amortisation and depreciation.

## Will earnings increase as amortisation ends?

The end of goodwill amortisation will enhance earnings of companies with significant goodwill balances. The transition rules do not require restatement of past transactions, so there may be an immediate positive impact on earnings.

A study<sup>1</sup> performed on the top 10 listed companies by market capitalisation on the Singapore Stock Exchange showed that on the average, net profit will increase by 15.1% and earnings per share will increase by 7 cents, upon the application of the new standard.

However, more intangible assets identified in new transactions may result in more amortisation in the future, not less. Combined with the impact of new treatments for restructuring costs and

<sup>1</sup> The study was performed based on information extracted from Bloomberg as at 31 August 2004.

negative goodwill, earnings may well decrease. In addition, earnings may potentially be more volatile as impairments are most likely to occur in years of already poor economic performance, thereby depressing profits in difficult years.

### Impairment testing

The annual impairment test on goodwill and intangibles with indefinite useful lives has to be performed at the cash-generating unit (CGU) level, being the lowest level at which goodwill is monitored for internal management purposes. A CGU is by definition the smallest identifiable group of assets that generates cash inflows largely independent of the cash inflows from other assets of the group. This essentially means that CGUs with impairment cannot be 'subsidised' by CGUs with no impairment.

In addition, disclosure of key assumptions and a sensitivity analysis on the key assumptions is required. This will demonstrate the range within which the assumptions may change before the carrying amount of the CGU exceeds its recoverable amount. Users of financial statements can thus understand the assumptions behind the calculations and their impact on the financial statements.

The new requirements also stipulate that there will not be impairment if the carrying value of the CGU is lower than the fair value or value in use of the CGU. To determine the fair value or value in use of a CGU, an appropriate valuation model has to be identified, a job that is perhaps best left to the valuation specialists.

### Increased deal transparency

Without doubt, the increased disclosure requirements will provide analysts and shareholders with more information. This may in turn elicit more pertinent questions. It is therefore essential that CEOs and CFOs have an in-depth understanding of the issues and are in a position to explain the details to the market as well as to the wider investment community. Time spent on considering the financial impact to proposed acquisitions can reap benefits in the form of confidence and trust from shareholders and analysts, through accurate and well-prepared disclosures at annual general meetings and analysts' briefings.

## So is goodwill reflective of a good buy? Or should we impair and bid goodbye?

### Conclusion

So is goodwill reflective of a good buy? Or should we impair and bid goodbye? The intrinsic value of goodwill, if any, will increasingly become more apparent when acquirer companies adopt the standard. The more stringent impairment test will highlight the success or otherwise of these deals and any loss of value will be immediately expensed off to the profit and loss. This would result in a more immediate indication of whether companies have overpaid for their acquisitions.

As the real value of a deal becomes more transparent, it is critical for investors, analysts and CEOs to carefully consider whether a particular transaction is indeed a good deal. For this reason, rigorous evaluation of target companies during the acquisition process is necessary. Thorough evaluation will also identify and ensure that the deal is able to withstand greater market scrutiny, and that it will enhance shareholders' value.

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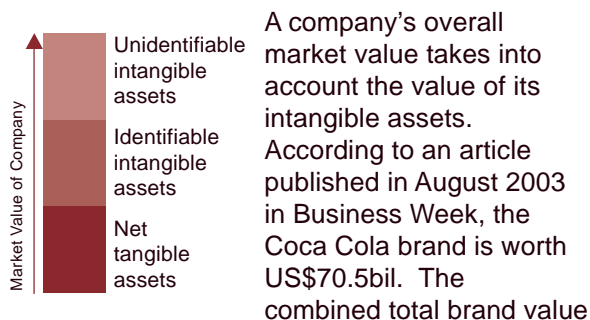


BY LUCY GWEE Transactions – Valuation & Strategy

## Valuation of Intangibles

FRS 38 defines an 'intangible asset' as 'an identifiable non-monetary asset without physical substance'. Intangible assets include intellectual property such as patents, trademarks, copyrights, trade secrets and industrial know-how as well as customer lists, software license, franchise agreements, trained workforce, networks, etc. These assets are rapidly becoming a core source of wealth creation in many sectors of the economy.

## Intangibles Make Up More Than Half Of Market Capitalisation For Some Companies



of the top ten brands in Singapore is worth only about 10% of Coca-Cola's brand value!

At times, the value of intangibles may contribute to more than half of its market capitalisation. Let us take a look at a sample of local companies. For example, the 'implied' intangible value of Eu Yan Sang and UOB is about 53% of their market capitalisations (See Figure 1). Eu Yan San's brand value constitute about 60% of its implied intangible value. On the other hand, the brand value of UOB is assessed to be S\$1.2bil, representing 10% of its implied intangible value. The rest of UOB's intangible value can be attributed to its marketing-related intangibles such as its customer relationship, branch network, customer list and database, etc.

## Capitalising on your Intangibles To Create Wealth

Intangibles, as we have seen, are key contributors to the earning power of a company. Yet many companies often fail to leverage and capitalise on the opportunities to exploit its intangibles. Like any other revenue-generating tangible asset, intangibles can provide opportunities for commercial exploitation. This can range from an outright sale to licensing, to gaining a competitive edge in the marketplace with specialised trade secrets.

Often, companies fail to identify all the intangible assets they own and/or control. Hence, it is critical for every organisation to put in place a system to manage its intangible assets. Effective management of intangible assets involves systematically identifying and protecting these assets, assessing their potential value, devising and executing appropriate strategies to exploit these assets. In this article, we will focus on assessing the value of intangible assets.

Although the commercial value of intangible assets, including intellectual properties, is widely acknowledged and frequently transacted, the valuation of these intangible assets generally attracts a degree of skepticism and reservation. This arises primarily because there is doubt as to whether the value of intangibles can be reliably measured.

Companies (Figures in SGD mil)	Market Capitalisation <sup>1,2</sup> (a)	Net Tangible Assets (NTA) <sup>2</sup> (b)	Value of intangibles? (c) = (a) - (b)	Brand Value (Ranking) <sup>3</sup>
UOB	21,543	9,816	11,727	1,211 (2)
Asia Pacific Breweries	1,929	764	1,165	943 (4)
Singapore Airlines	13,156	11,454	1,702	304 (7)
OSIM	447	93	354	95 (12)
Eu Yan Sang	109	51	58	35 (15)

There are many methods of valuing intangible assets, some of which are more robust than others. Unfortunately, there is a lack of general consensus as to which methods are preferred. Various accounting standard setting bodies around the world are beginning to indicate what they believe to be acceptable methods of valuation for financial reporting purposes.

Figure 1: Implied Value of Intangibles of Singapore Companies

1 Based on last traded share price as at 8 October 2004

2 Source: Bloomberg

3 Source: International Enterprise Singapore "Singapore Brand Awards 2003"

## Approaches to Valuing Intangible Assets

The fair value of an intangible asset is defined as the amount that a party would pay for the asset, at the acquisition date in an arm's length transaction between knowledgeable and willing parties, based on the best information available.

There are three basic approaches used to determine the fair value of an asset. These are the cost, market and income approaches. Although in practice many methods are used, all such methods can be categorised as variations of one of the three approaches.

It is generally accepted that the determination of the fair value of an intangible is as much a science as it is an art. As such, it is very common for the results of one valuation method to be corroborated with the results of one or more other methods in the determination of the fair value of an intangible.

### Cost Approach

The cost approach values an intangible asset by accumulating the costs that would currently be required to replace the asset. The underlying premises of the cost approach is that the cost of the intangible asset is commensurate with the economic value of the usage that the property can provide during its life, and that an investor would not pay more than the cost to reproduce or acquire the asset.

Whilst this approach is suitable for some assets, particularly for easily replicable assets like simple software, care should be exercised in choosing this approach as cost is often not a reliable guide to value. The cost approach tends to look backwards in time, which is seldom the way buyers and sellers view assets or transactions.

Historical costs may not account for the incremental profits that an asset may generate. Conversely, not all costs are efficiently and effectively incurred. For instance, the vast amounts of investment on pharmaceutical research projects may yield minimal value.

### Market Approach

The market approach values the asset based on comparison with sales of similar assets. The transaction price, as a ratio of an asset attribute such as sales, is used to derive a market multiple. This market multiple is then applied to the attribute of the asset being valued to obtain an indicative value of the subject asset. One may use sales, EBITDA, EBIT, net income, operating cash flow, revenue, etc to derive the market multiple. In an efficient market, this is deemed the best method because the market represents the economic environment where arm's length transactions occur between the buyer and seller.

However, in practice it is difficult to identify intangible assets with 'similar' characteristics. The availability of any information relating to the transaction details as well as the lack of an active market place exacerbate the problem. Even if the price is available, the other problem is that intangible assets are often 'bundled' with other assets, so the price paid for an individual intangible asset is not observable with certainty. Nonetheless, this approach is most straightforward, easily understood and usually applied as a counter-check to other methods of valuation.

### Income Approach

This is the most common approach for valuing intangible assets. The principal notion supporting the income approach is that it views value as arising from the expectation of future income stream(s) and cash flows.

There are several variations to the income approach. We examined four commonly used methods for valuing intangible assets:

- Excess profits method
- Premium pricing method
- Cost savings method
- Royalty savings method

#### 1. Excess profits method

The excess profits method determines the value of the intangible asset by capitalising the additional profits generated by the business owning the intangible asset over and above those generated by similar businesses, which do not have the benefit of the intangible asset.

The basic theoretical premise is that the trade name and/or other intangible assets will allow the owner to earn a profit that is greater than what a competitor would earn without the benefit of the trade name.

There are various ways in which the excess profits may be calculated. For example, some ways would be by reference to a margin differential or comparing the return on capital employed earned by the business owning the intangible asset with that earned by companies without such benefits. The calculated excess profits expected to be earned over the life of the intangible asset in question are then discounted to the present day to arrive at an estimated value of the intangible asset.

Under this method, it is important to ensure that the excess profits identified are specifically attributable to the intangible asset in question and not some other factors (such as an efficient production facility or distribution network) that relate to the business as a whole.

Another important consideration of this method is that the comparable company may lack the subject company's intangible asset but it could benefit from other intangible assets of its own. In this scenario, the comparable company's operating margins would also include returns from its own intangible assets, and the inference is that the excess profit of the subject company must be higher.

## 2. Premium pricing method

The premium pricing method is a variation on the excess profits method and is often used to value brands in the consumer products sector where it is common for a branded product to be more expensive than a non-branded equivalent.

The value of this additional revenue projected over the life of the brand, net of marketing and other brand support costs expected to be incurred to achieve this revenue, is then discounted to the present day to provide a value of the brand.

A drawback of this method is that it is very difficult to find a truly generic, non-branded product. In the food sector, where stores often sell both branded and their 'own label' or 'no-frills' products, the store's own brand itself carries certain value.

## 3. Cost savings method

The cost savings method values the asset by calculating the present value of the cost savings that the business expects to make as a result of owning the intangible. This is usually a result of an efficient process or secret technology.

Whilst a business can usually calculate the costs it has saved since it introduced the new process, it can be more difficult to estimate whether a third party would save more or less costs if they introduced the same technology to their own business.

## 4. Royalty savings method

The royalty saving method is based on the principle that, if the business did not own the asset, it would have to in-license it in order to earn the returns that it is earning.

Alternatively the business could out-license the asset if it did not wish to use it. Under this method, the value of the intangible is estimated by capitalising the royalties saved due to the company's ownership of the intellectual property. In other words, the owner realises a benefit from owning the intangible asset rather than paying a rent or royalty for the use of the asset.

Royalty savings are typically determined based on the application of an arm's length royalty rate to the future revenues expected from the sale of the product or service associated with the intangible, and the value is determined based on the present value of the royalty stream that the business is saving by owning the intangible. Trade names and trademarks are typically valued using this method.

Determining an appropriate royalty rate is a key part of a valuation using this method. One apparent and simple way would be to find an exact comparable transaction between unrelated parties. Yet the existence of an 'exact' comparable may be elusive. In the absence of the exact comparable, justification for an appropriate royalty rate often defaults to weak or 'inexact' comparables. This is one of the major difficulties of this approach.

...value brands in the consumer products sector where it is common for a branded product to be more expensive than a non-branded equivalent.

## Choosing the Appropriate Valuation Method

When assessing the value of your intangible assets, no one single method can be sufficiently conclusive. A good practice is to use a few methods to substantiate one’s initial findings. Some of the above methods are more suitable for certain assets than others and there is always the practical limitation of what information is available.

Perhaps the most important guide to your choice of valuation method is to consider how the asset creates value for its owner:

- Does it generate additional revenue? If so, then a method based on revenue is probably most appropriate.
- Does it save costs? If so, then a method based on costs saved could be used.
- Does it give a competitive advantage without directly generating additional revenues or saving costs? In this case, a method based on replacement costs may be the answer.

Figure 2 shows you some common methods used to value various classes of intangible assets.

Assets	Market approach	Cost approach	Income approach			
			Excess profit	Premium pricing	Cost Saving	Royalty relief
Brands	•		•	•		•
Patents		•	•		•	•
Know how	•	•	•		•	•
Customer lists	•	•				
Franchises	•	•			•	•

Figure 2: Common methods for valuing frequently encountered intangible assets

## Dealing with Uncertainty and Risk

One of the reasons that many people are skeptical about placing a value to an intangible is that there is usually a greater level of uncertainty and risk(s) associated with the potential revenues from the exploitation of an intangible

A good practice is to use a few methods to substantiate one’s initial findings.

asset than from a tangible asset. How can these uncertainty and risks be dealt with in the valuation so that it is reasonable, robust and reliable enough for financial reporting purposes?

To a certain extent, the income approach which uses the Discounted Cash Flow (DCF) method of valuation accounts for the time value of money, and to a certain degree, the riskiness of cash flows. It is possible to use a risk adjusted discount rate to discount the cash flows, or to adjust cash flows to reflect riskiness, or changing riskiness over time.

For instance, one way to deal with the uncertainty that the future cash flows will not materialise, particularly where there is a higher than usual level of risk, is to use expected cash flows rather than the simple discounted cash flow approach. In the

expected cash flow approach, the principal risk associated with the future cash flows are identified and dealt with using a probability approach and option techniques. Thus, for example, when estimating the probability of certain events occurring, we can factor in the impact of the total market being larger or smaller than expected or take into account the impact of competition. This

makes the valuation more robust. These techniques have particular relevance in evaluating portfolios of products or applications under development, for example in the pharmaceutical industry. An example of this technique is shown in Figure 3.

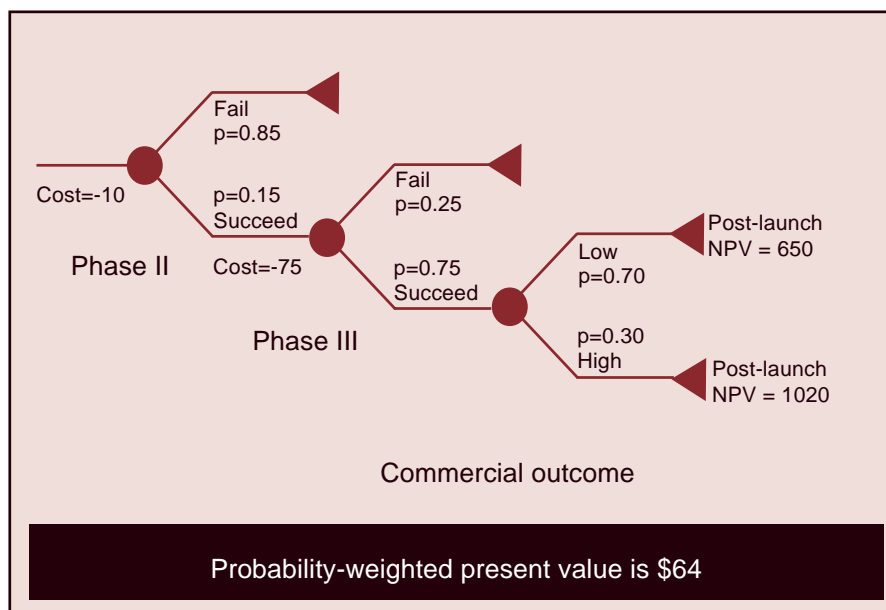


Figure 3: Probabilistic Discounted Cash Flow

Under a probabilistic DCF approach, the situation is usually such that all the information involved in making a decision about the intangible is highly uncertain, and the best that can be done is to consider the costs and revenue probabilistically. The end result being a frequency distribution of Net Present Value (NPV) values. However such a method, and other so-called 'Monte Carlo' simulations can be time-consuming and are constrained by the difficulties in establishing the probability distributions needed.

The DCF method is, and will remain, the primary tool in valuation. Yet it can be difficult to use DCF to justify the market values of start-ups or some other companies heavily centred on intangible assets since many may not even have positive cash flow and/or revenue. Their market value too may not reflect the various strategic options that it is currently exploring. For instance, a company could be deciding whether to invest in the prototype of its technology, or it could in the midst of a critical licensing deal for its intangibles with a global player. If materialised, it could yield a substantial leap in its cash flow. The standard DCF does not include the value of such options in its calculations.

Hence in valuing such companies, other decision tree analysis or options pricing theory could be used to complement and supplement the traditional DCF method. The three most common ways include decision tree analysis (DTA), Black-Scholes and binomial analysis.

The advantage of such methods over the traditional DCF method is that it builds in the value of 'flexibility' encountered in a patent or any other intangibles. For example, it takes into account to some extent the ability to abandon the patent.

Each method is appropriate for different situations and require different inputs. Such methodologies are becoming popular, especially in the pharmaceutical, and oil and gas industry. There are many factors to consider when assessing value under different scenarios and industry/regional

profiles. Separate discussions will be required to expound the detailed methodology and examples in valuing intangibles under uncertainty.

## Conclusion

So, can an intangible asset be reliably measured? The answer is yes, provided that the appropriate approach and methodology is selected and properly applied.

It is equally important to add that a keen sense of business acumen combined with rational judgment are critical inputs to the valuation process.

Valuation is both an art and a science.

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BY JENNY GOH *Human Resource Services – International Assignment Solutions*

## Benefits-in-kind Reap Benefits in Tax

Tax is often one of the key considerations when companies evaluate the value of starting an operation in a new country. Yet, one of the crucial components of tax planning may inadvertently be overlooked in the rush to expand. And this tends to form a large chunk of expenses, especially for the professional or consultative services industry.

Remuneration is crucial in sourcing for employees. It is no secret that it is the people who make or break an organisation, even in the realm of managing and improving systems and hardware. Attractive remuneration packages give employers an edge in the available pool of suitable employees. This does not necessarily mean that the cost to the company has to increase correspondingly. Simply restructuring how your company offers benefits to employees and educating employees on how the benefits structured by your company actually reduces their tax – thereby increasing their disposable income – may already reap you unexpected results.

Sometimes, certain benefits may also be perceived to be more appealing than outright higher cash remuneration.

Isn't it time to take a closer look at the benefits you have been missing out? Time to relook at ways of attracting employees who may potentially further grow your business?

### Structuring the remuneration package

One of the personal tax minimisation strategies in Singapore lies in the structuring of the remuneration package. Generally, all cash remuneration is taxable in full. Certain fringe benefits, if properly structured, are given favourable tax treatment.

### Fringe benefits that save you money

Do you know how you can enjoy tax-free fringe benefits? Here's a quick run-through of such potential benefits.

- **Accommodation**

Housing allowance provided to the employee is taxable in full. Where the employer provides housing accommodation to the employee. The taxable benefit is the lower of 10% of the employee's total remuneration or rent on the unfurnished premises paid by the employer, less the housing contribution paid by the employee. In most cases, 10% of the total remuneration works out to be the lower figure. Furniture and fittings provided by the employer or landlord are taxed at nominal rates prescribed by the IRAS.

To enjoy this concession, the employer must clearly state its intention to provide accommodation to the employee, enter into the tenancy agreement with the landlord and pay the rent directly to the landlord.

- **Home leave**

Cash in lieu of home leave passage is taxable in full. However, where the employer pays for leave passage to home country, concessionary tax treatment is available – only 20% of the cost of air-tickets paid by the employer for the employee and his family members to go back to their home country (limited to one trip for employee and spouse and two trips per qualifying dependent child in a year) is taxable. Full tax remission for home leave passages is allowed if the employer enjoys certain tax incentive status (e.g. pioneer, Operational Headquarters status, etc) and the employee is involved in those activities. Costs of additional home leave passages, passages to other destinations, and other expenses incurred during the eligible leave passage (e.g. hotel, meals, etc) are fully taxable.

The above concessionary treatment is not applicable to Singaporeans and Singapore permanent residents and where the tax incentive status is granted to the company after 1 January 2004.

- **Car**

Instead of paying the employee a car allowance, the employer may choose to provide a company-owned car or a leased car (where the lease agreement is signed between the employer and the leasing company). Under this arrangement, the employee is taxed on the benefit derived from the private use based on the IRAS' prescribed formulae. The taxable value to the employee depends on whether the car is company-owned or leased, and whether the employer bears the cost of petrol, but is generally lower than the taxable value of a car allowance.

It is important to note that the employer cannot claim any corporate tax deduction for expenses incurred on private plated cars, regardless of whether it is company-owned or leased. Although the above arrangement results in lower tax liability to the employee as compared to receiving car allowance, it may result in a higher cash outlay to the employer if the company is paying tax at the full corporate tax rate since the latter is tax deductible. CPF implications of car allowance versus car benefit should also be taken into consideration.

- **Club membership**

Where the employer provides a corporate membership, the entrance fee paid by the employer is not taxable on the employee. On the other hand, entrance fee paid by the employer for an individual membership is generally taxable on the employee. Monthly subscriptions paid by the employer whether for corporate or individual membership are taxable on the employee only to the extent that the employee uses the club facilities for non-business purposes.

- **Employer's contributions to overseas pension fund**

Employees usually prefer to remain on their home country pension scheme, if possible, during their assignment in Singapore. Employer's contributions made in respect of an employee to any provident or pension fund (including social security) constituted outside Singapore are taxable on employees in the year the contributions are made.

As a concession, mandatory contributions are not taxable if certain conditions are met. Individuals who are tax residents and qualify for the Not Ordinarily Resident (NOR) status, may claim tax exemption on employer's contributions to non-mandatory pension fund/ social security, subject to limitations. The NOR scheme applies to an individual who is a tax resident in the current tax year but non-resident in the 3 preceding tax years.

- **Stock options/ share awards**

Gains on stock options or share awards arising from Singapore employment are taxable. However, partial tax exemption on option gains is available under the Entrepreneurial Equity-Based Remuneration Scheme (EEBR) and Company Employee Equity-Based Remuneration Scheme (CEEER).

Under the EEER scheme, 50% of the option gains, up to a cap of S\$10 million over a 10 year period is exempt, while the CEEER exempts 100% of the first S\$2,000 and 25% of the remainder, up to a cap of S\$1 million over a 10-year period.

Tax rules on stock option/ share award gains are usually complex and an individual's tax situation can be influenced by changing personal circumstances, laws and regulations.

Individuals who move into or out of Singapore between the grant of their options and their vesting and/or exercise could be taxable in several locations. Thus, it is important for individuals to take particular care in assessing their tax requirements.

- **Interest subsidy/interest-free loans**

Where an employer provides an employee with a loan, either interest-free or at a rate below that of the market rate, a benefit is derived by the employee and such deemed benefit is taxable to the employee. However, as an administrative concession, such benefits would not be taxable to the individual if he does not have substantial shareholdings or control or influence over the company. This concession may be extended to a director, subject to meeting certain criteria.

Where an employer pays interest, in full or in part, on loans obtained by the individual, such benefit does not fall within the scope of the above administrative concession and is thus taxable.

- **Education subsidy/scholarships**

Generally, where the employer provides an employee with an education subsidy/ scholarship, the IRAS may agree to a non-taxable position if the training/course leads to an acquisition of knowledge or skills which are related to the employment, and/or the employee concerned would be bonded to the company for a certain period of time.

- **Long service award**

As an administrative concession, the IRAS will not tax non-cash awards if they have little or no commercial value.

- **Life insurance premiums**

Premiums paid by an employer on an insurance policy where the employee and/or his nominee is the beneficiary, are taxable on the employee. However, insurance premium(s) paid by the employer is exempt from tax if the employer is the owner and beneficiary of the policy, even if it is intended that proceeds will be given to the affected employee or the employee's family.

Basic medical benefits (including dental) provided by the company to its employees are not taxable for Singapore tax purposes by concession.

- Dental/medical, hospitalisation and surgical benefits

Basic medical benefits (including dental) provided by the company to its employees are not taxable for Singapore tax purposes by concession.

- Free/subsidised food and drinks, and free transport between pick-up points and the location of employment

With effect from 1 January 2004, free or subsidised food and drinks provided by employers to employees (e.g. coffee/tea/snacks provided in the pantry, company sponsored meals etc) and free transport services between pick-up points and the location of employment, will no longer be taxable for Singapore tax purposes by concession.

### Conclusion

It is clear that employers can reduce employees' tax costs significantly by judiciously providing certain benefits-in-kind instead of cash, without increasing costs to themselves. Employers reap the benefits where as part of the remuneration package, they bear the employees' taxes. Obviously other details such as the administrative costs of delivering such benefits and corporate tax implications should also be given apt consideration when assessing at the overall cost-benefits.

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### Illustration of tax benefits from tapping on benefits-in-kind

	Taxable income (S\$)	
	With cash remuneration only	With benefits-in-kind
Base salary	200,000	200,000
Bonus	50,000	50,000
Overseas allowance	90,000	NA <sup>1</sup>
<ul style="list-style-type: none"> <li>Housing accommodation Rent paid by employer on an unfurnished apartment @ S\$4,000/month x 12 = S\$48,000</li> </ul>	NA	26,181 <sup>2</sup>
<ul style="list-style-type: none"> <li>Home leave One home leave passage for self @ S\$8,000</li> </ul>	NA	1,600 <sup>3</sup>
<ul style="list-style-type: none"> <li>Leased car Leased car charges @ S\$1,500/month x 12 = S\$18,000, petrol borne by employee</li> </ul>	NA	7,714 <sup>4</sup>
<ul style="list-style-type: none"> <li>Club membership Term club membership @ S\$5,000 per year, 50% business usage</li> </ul>	NA	2,500
<ul style="list-style-type: none"> <li>Overseas pension fund Employer's contributions to home country retirement plan @ S\$10,000/year</li> </ul>	NA	0 <sup>5</sup>
<ul style="list-style-type: none"> <li>Dental and medical care @ S\$1,000/year</li> </ul>	NA	0
<b>Total</b>	<b>340,000</b>	

Cost to employer (net of tax deduction) S\$275,600<sup>7</sup>

S\$272,000<sup>6</sup>

Cost differential of S\$3,600

Tax payable by employee<sup>8</sup> S\$39,589

S\$49,860

Tax differential of S\$10,271

<sup>1</sup>Overseas allowance repackaged as:

- 1) Housing accommodation of S\$48,000 (S\$4,000 x 12)
- 2) Home leave passage of S\$8,000
- 3) Leased car charges of S\$18,000 (S\$1,500 x 12)
- 4) Term club membership of S\$5,000
- 5) Employer's contributions to overseas pension fund of S\$10,000
- 6) Dental and medical care of S\$1,000

<sup>2</sup> Lower of 10% of total remuneration or rent paid by employer = 10% (S\$200,000 + S\$50,000 + S\$1,600 + S\$7,714 + S\$2,500) or S\$48,000

<sup>3</sup> S\$8,000 x 20%

<sup>4</sup> 3/7 x (S\$1,500 x 12)

<sup>5</sup> The individual qualifies for NOR status and enjoys full exemption on the employer's contributions to overseas pension fund.

<sup>6</sup> Assuming that company is paying corporate tax rate @ 20%: S\$340,000 x 80% (net of corporate tax deduction @ 20%)

<sup>7</sup> Due to non-deductibility of leased car charges: (S\$340,000 – S\$18,000) x 80% + S\$18,000

<sup>8</sup> Assuming that employee is entitled to self relief of S\$1,000, wife relief of S\$2,000 and child relief of S\$4,000





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