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## Intangibles and IFRS 3: seen but not heard?

### Introduction

Since January 2007, when we published our report 'IFRS 3: The First Year', there has been a growing disquiet against the accounting profession in its treatment of intangible assets. The report analysed how the FTSE 100 applied the International Financial Reporting standard IFRS 3, on Business Combinations, in its first year of implementation and revealed disturbing examples of individual companies which did not apply the standard adequately. The overall position was also disturbing. 53% of the £40bn spent on acquisitions was unaccounted for and dumped into the vacuum of goodwill because intangible assets were not recognised separately or were significantly undervalued. Frequently, no description of the factors that make up goodwill is disclosed.

### The critics

The fundamental flaws with both the accounting standard and its implementation are undermining the credibility of the accounting profession in the area of intangible value. Its treatment of intangible assets is the catalyst for attacks against the industry from all sides. Businessmen ignore it as a compliance cost of doing business, much like filling out a useless form. Lawyers tend to ignore it. Academics deride the accounting industry's treatment of intangible assets as worthless. Government bodies dismiss it as meaningless. Marketers see the profession as divorced from reality and are given no input into the values attributed to the assets they manage. Licensing agents view intangible values and disclosure in annual reports as obstructive. Analysts all but ignore it, relying more on their own research. The World Intellectual Property Organisation (WIPO) highlights the flaws and questions the motives of the accounting profession. Regulators are wary of the industry's implementation but are not fully empowered to enforce or change the standard. And investors either completely ignore it or question management's ability, seeing as so much of their money is being inadequately accounted for. Management might be responsible for reporting such meaningless figures on intangible assets. Yet they claim not to view this area as a priority and go through the minimum level of hoops of compliance, influenced by their auditors. The auditors claim to be complying with the standard, and to a limited degree they are. The standard itself – which the accounting industry created the need for and wrote – is now generating extra fees of in the millions every year. But it has significant limitations.

### The flaws

IFRS 3 (Business Combinations) has a number of fundamental flaws regarding the treatment of intangible assets which render the reporting – even if applied properly – inaccurate and misleading for the unwary reader:

1. Only acquired intangibles are valued: only acquired intangible assets are allowed on the balance sheet. Internally generated intangibles may not be put on the balance sheet. If you build a machine or a building, their value can be put on the balance sheet so why not intangibles? The reason cited is one of recognition criteria which states that an asset may only be put on the balance sheet if the "item has an appropriate basis of measurement and a reasonable estimate can be made of the amount involved". Simply, without the support of a transaction value, the accounting profession perceives valuing intangibles as too difficult and subjective so the solution is to ignore it.
2. Treatment of goodwill: IFRS 3 requires goodwill to be identified and explained. However, this has only occurred in a minority of instances in practice, and even then minimal explanation was given. Surely the company must know what the goodwill consists of because it must have been part of the rationale for the acquisition; the synergies, economies of scale or portfolio effect for instance. If they can't describe it, why did they buy it?
3. Undervaluing of intangible assets: the standard incentivises the accounting industry to place low values on intangible assets. This is because, following the required impairment reviews, if the asset has lost value then the company must take a charge to the profit and loss account. Low values are therefore given to avoid the risks of impairment charges. Absurdly, if the value of the asset increases, the increase will not be recognised.
4. Historic cost: As there can be no recognition of an increase in value for an intangible asset, the values of all the assets on a company's current balance sheet are at historic cost, and therefore out of date. These limitations of IFRS 3, which the accounting profession created, and the poor level of compliance renders the accounting for intangibles pretty useless. This is the basis of objection from outside the accounting profession.

### The positives

There are a few reasons to be optimistic. In 2006, there were a couple of examples of encouraging reporting of intangibles. Cadbury Schweppes allocated 66% of the acquisition cost of Green & Black's to brand with only 18% to goodwill. This seems a sensible allocation as the 18% represents the obvious synergies of Green & Black's operating within the international Cadbury machine and the premium they would have had to pay to purchase the brand. Diageo also reported its acquisition of Bushmills whiskey well, with 58% of the £144m allocated to brand and 17% to goodwill. Following our report in 2007, the UK regulatory body, Financial Reporting Review Panel, published its 'Annual Report 2007' in which it criticised companies for their non-disclosure of an adequate description of goodwill under IFRS 3. A little more explanation of goodwill is now being given in annual reports by companies such as BT and SABMiller. A few extra lines of explanation may seem inconsequential, but it's a lot better than before the publication of our first report. The US and International Accounting Standards are also converging. Nothing is in essence improving, but perhaps a global platform is being built which will facilitate greater change in the future. Also, before FASB 141 and IFRS 3, intangible assets were rarely allowed on the balance sheet under any circumstances. So allowing acquired intangibles to be included is a very positive step.

### Conclusion

Is it all too little too late? The jury's out. What is not in doubt is that the accounting profession is in danger of being marginalised over its treatment of intangible assets. All that's needed though is for the values to be sensible and disclosure transparent enough to enable outsiders to base decisions on reasonable information.

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