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The failure of IFRS 3

In force in the UK since the end of 2005, IFRS 3 was supposed to ensure that company accounts were generally more transparent for business acquisitions and specifically provided more information about the value of intangibles. In reality, this has not happened

By **Thayne Forbes**

There have been a number of initiatives in the accounting world recently about accounting for the value of intellectual property. International Financial Reporting Standard (IFRS) Number 3 on Business Combinations places great emphasis on the need for intangible assets obtained through a business acquisition to be separately valued and recognised in the accounts. This is part of a drive for globally consistent accounting standards, and to improve accounting for business combinations (an area which has seen much creative accounting in the past).

IFRS 3 was supposed to make accounting for business combinations a boardroom issue, to bring increased transparency and to give the market a greater insight as to what has been acquired. A key implication of IFRS 3 was that many more intangible assets were likely to be recognised compared with previous UK accounting standards.

All International Financial Reporting Standards (including IFRS 3) have had to be adopted by larger quoted companies reporting in the UK for accounting periods ending 31st December 2005 and after. So by now most of these companies will have reported on the basis of IFRS 3 for the first time. We have researched this in depth and have found:

- The true value of intellectual property is being significantly under-reported.
- The level of information given is so short of detail that it is of little use.
- This underlines the inherent limitations within the IFRS 3 framework, although these are not articulated for users of accounts.

Some terms used

The report and accounts of a large company and IFRS 3 are full of technical accounting jargon and therefore really need a high level of specific knowledge (and its application in practice) for any attempt at real interpretation. It is difficult to discuss these subjects without getting immersed in this, but some explanation of terms are necessary.

Intangible assets

These include intellectual property but cover a somewhat broader class of asset, being non-monetary assets without physical substance, arising from contractual/legal rights or being separable. IFRS 3 gives many examples of intangible assets (see table on page 9), which indicates that it is pretty equivalent to intellectual property, as well as some broader concepts.

Intangible assets should be valued only where their fair value can be measured reliably, and International Accounting Standards indicate that the value of most intangible assets can be measured reliably.

Goodwill

The excess of the acquisition cost over the sum of the individual values of the underlying net assets, including intangible assets. This is sometimes referred to as a type of intangible asset, but it is not included in intangible assets in this article.

Purchase price allocation

This is a term used in practice to describe the allocation of the purchase price of a business to values of underlying individual assets and liabilities (including intangible assets).

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Intangible assets and IFRS 3

A	**Marketing-related intangible assets**
1	Trademarks, trade names, service marks, collective marks and certification marks
2	Internet domain names
3	Trade dress (unique colour, shape or packaging design)
4	Newspaper mastheads
5	Non-competition agreements
B	**Customer-related intangible assets**
1	Customer lists
2	Order or production backlog
3	Customer contracts and the related customer relationships
4	Non-contractual customer relationships
C	**Artistic-related intangible assets**
1	Plays, operas and ballets
2	Books, magazines, newspapers and other literary works
3	Musical works such as compositions, song lyrics and advertising jingles
4	Pictures and photographs
5	Video and audiovisual material, including films, music videos and television programmes
D	**Contract-based intangible assets**
1	Licensing, royalty and standstill agreements
2	Advertising, construction, management, service or supply contracts
3	Lease agreements
4	Construction permits
5	Franchise agreements
6	Operating and broadcast rights
7	Use rights such as drilling, water, air, mineral, timber-cutting and route authorities
8	Servicing contracts such as mortgage servicing contracts
9	Employment contracts
E	**Technology-based intangible assets**
1	Patented technology
2	Computer software and mask works
3	Unpatented technology
4	Databases
5	Trade secrets

Top-level results of research

We analysed intangible asset values reported by the FTSE 100 companies in their most recent published reports and accounts. Of these companies, 89 had reported under IFRS. We analysed 84 of them, which valued assets and liabilities underlying business combinations with a total deal value of £39.8 billion. The relative allocation of value was goodwill – 53%; intangible assets – 30%; and tangible assets less liabilities – 17%.

The amount overall attributed to intangible assets is surprisingly low, as something of the order of between 30% and 70% of business value is generally attributed to them. There is also a big question mark over what the goodwill actually is. There is hardly any information on this in these published accounts, just a few comments stating it is an assembled workforce, synergies or future growth. So, what is this goodwill? It is certainly capable of being analysed and given that IFRS 3 is supposed to be a spotlight on acquisitions it must have been turned off generally most of the time.

It is more likely that the intangible assets have been generally undervalued. There is another potential explanation too, which is that there have been overpayments for the businesses. This does happen; Vodafone's acquisition of Mannesman in April 2000 is an example of a substantial overpayment, but only recognised by way of impairment of goodwill in April 2006. Some or all of this impairment would have been due to original overpayment.

However, IFRS 3, with its greater emphasis on transparency of acquisition accounting and the valuation of all intangible assets, means that such an overpayment for a business should be identified earlier. However, none of these FTSE 100 companies have reported any overpayment (or why substantial goodwill does not indicate this) for a single acquisition.

IFRS 3 does set out a standard classification for reporting of intangible asset values, but this has not been consistently followed, in contrast to the reporting of other asset and liability classes. It seems very poor that even the higher-level classification into marketing, customer, artistic, contract and technology cannot be followed with over £4 billion of intangible assets aggregated across classifications. However, we have analysed the information reported, which indicates that the values of the main categories of intangible asset are marketing related, customer related, technology related, contract related and mixed (see chart on page 10).

It makes sense that marketing and customer-related intangibles should have substantial values, but even so they look too low. The contract-related intangibles are mainly licences in the mobile telecommunications industry and, given the Vodafone experience, their value might be questionable. There is, however, little in those accounts to indicate whether this value is reasonable.

The mixed category is where descriptions have been aggregated or where they are described generically as intangibles or other intangibles. For example WPP reported £319 million as "acquired intangibles" on its £928 million acquisition of Grey – hardly transparent reporting! Disclosure of this sort is usually so limited as to be of little value.

Date of application of IFRS 3

IFRS permits the application of IFRS 3 either retrospectively or two years before the accounting reference date for first application (ie, for the reporting year and the comparative prior period). This means that reported goodwill in the balance sheet is compiled inconsistently, and is summarised as follows:

- Prior to 1998 – goodwill usually written off immediately.
- From 1998 to 2005 – goodwill capitalised and amortised.
- From 2005 onwards – goodwill capitalised and reduced by impairment charges.

In fact, this research shows none of the FTSE 100 companies elected to apply IFRS 3 retrospectively. This means that for all of the other companies, intangible assets acquired prior to two years before the accounting reference date have not been accounted before by reference to IFRS 3. In other words, for those companies the reporting improvements anticipated by IFRS 3 have been applied only for the last two years.

The Bushmills and Green & Black's acquisitions

That said, some of the valuations look reasonable and give some useful information – for example, the two acquisitions of the Bushmills Irish whiskey business by Diageo, and Green & Black's chocolate by Cadbury Schweppes, for which the purchase price allocations are summarised on this page.

Insufficient information is disclosed to be sure, but this allocation appears reasonable from an overall review. It is no surprise that both acquisitions are of businesses with strong consumer brands and brand value forms a significant part of the price paid – £144 million for Bushmills (72%) and £25 million for Green & Black's (66%). There is little explanation for the goodwill on these acquisitions in either of the annual reports and accounts. However, it is possible to infer that Diageo would achieve significant value through synergies with Bushmills, in both increased sales from increased market power and cost savings from economies of scale. Also, for Green & Black's this would be attributable to value arising from synergies with Cadbury's business such as opportunities for future growth in international markets.

It also seems reasonable that there are no other intangible assets valued other than the brands. The Bushmills and Green & Black's brands are strong and other intangibles (such as customer relationships) will be of insignificant value compared with them.

Standard Chartered/Korea First Bank

The purchase price allocation for the acquisition of Korea First Bank by Standard Chartered is summarised on page 11. The proportion of intangible asset value relative to acquisition cost is very small, as illustrated in the chart, also on page 11.

An explanation given for goodwill in the accounts indicates significant synergies expected to arise from development within the Standard Chartered group and those intangibles such as workforce in place, which are not recognised separately. This presents certain difficulties:

- Korea is a new market for Standard Chartered and as such would not be expected to have synergies as significant as those implied by this level of goodwill.
- The Korea First Bank was clearly a significant business with a large number of customers. The intangible asset values, particularly the value of customer relationships, could be expected to be much higher than attributed (at £24 million which is less than 1% of the acquisition cost).

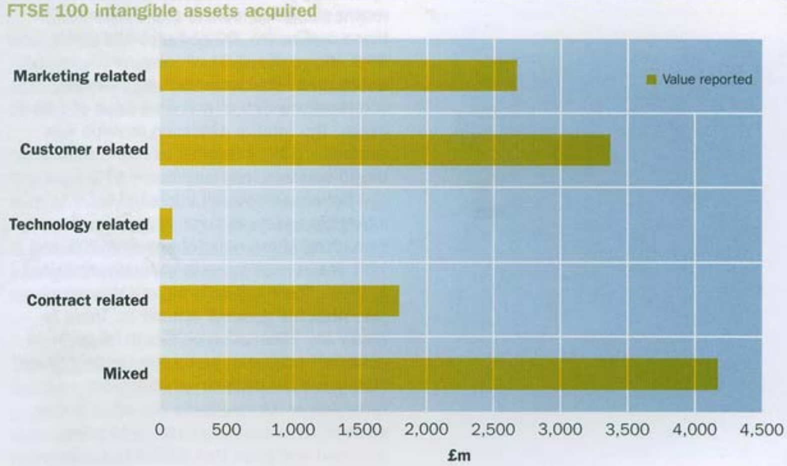
In the banking sector, brands frequently have a high value. And the value of customers can be much higher, particularly in retail banking. The two will be inter-connected and the key reason customers have such a high value in this sector is that customers do not switch their banks very often.

Standard Chartered valued the Korea First Bank brand at £86 million and

The Bushmills and Green & Black's acquisitions

Acquirer	Diageo	Cadbury Schweppes
Acquiree	**Bushmills**	**Green & Black's and others**
	25/08/2005 £m	**01/05/2005 £m**
Brands	144	25
Property, plant & equipment	25	
Working capital	37	
Other assets		6
Deferred tax	(50)	
Goodwill	43	7
Acquisition cost	**199**	**38**
Brands	72%	66%
Goodwill	22%	18%
Tangible assets	31%	16%

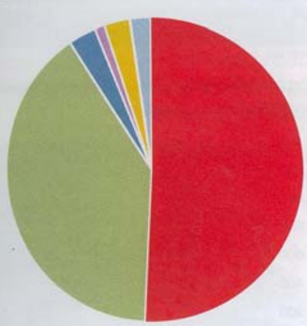
FTSE 100 intangible assets acquired



Standard Chartered acquisition of Korea First Bank

Acquirer	Standard Chartered	
Acquiree	**Korea First Bank 15 April 2005**	
	£m	**£m**
Brand names	86	
Customer relationships	24	
Core deposits	91	
Capitalised software	28	
Total intangible assets		229
Property, plant & equipment	1,088	
Investment securities	8,153	
Loans and advances to customers	31,455	
Cash and balances at central banks	2,321	
Other assets	1,901	
Total tangible assets		44,918
		45,147
Deposits by banks	(2,782)	
Customer accounts	(18,923)	
Debt securities in issue	(16,871)	
Subordinated liabilities and other borrowed funds	(1,280)	
Other liabilities	(3,323)	
Total liabilities		(43,179)
Minority interest		(333)
Net assets acquired		1,635
Goodwill		1,738
Acquisition cost		**3,373**

Korea First Bank PPA



customer relationships at £24 million, on an acquisition worth £3.373 billion. However, the reporting on the acquisitions by Banco Santander and Barclays acquisitions of Abbey in the UK and Absa in South Africa respectively indicated that brand and customer values were much higher relative to total acquisition cost. Using these as benchmarks, the Korea First Bank's brand value would be much higher, at between £135 million and £300 million, and the associated customer-related intangibles would also be much higher at £340 million to £1.4 billion.

Aviva's acquisition of RAC

The purchase price allocation for the acquisition of the RAC by Aviva is summarised on page 12. The relative values attributed are illustrated on the same page.

As far as the acquisition details are concerned, the levels of disclosure are less than normal, which makes the acquisition accounting far from transparent. Even the information summarised on page 12 has had to be derived by analysis of the accounts. There are, however, some comments in the annual report and accounts indicating that significant synergies through cost savings and increased revenues were expected from the acquisition. However, it also states that RAC is a well-known and highly respected brand, and that the aim was to generate value from the brand through this acquisition.

The RAC's brand and customer relationships most probably form the bulk of the value in the RAC business. While there may be synergies, these should not be used to justify a low value for the brand and customer relationships, and a high value for the goodwill. This is a distorted reporting of what was acquired.

Level of disclosure

Judging by the information we looked at, the level of disclosure between annual reports and accounts is patchy and inconsistent. Information on acquisitions is often aggregated and hard to interpret. It means that the role of intangible assets in acquisitions is not transparently reported.

Some details of impairment tests are given, again inconsistently, but only some of the key assumptions are disclosed, such as the period of cash-flow forecasts, growth rates to perpetuity and discount rates. However, the key assumptions – those underlying the forecast cash flows – are not reported.

The reason for the high levels of goodwill

There are likely to be two main reasons for the unduly high levels of goodwill:

- A lack of appreciation of the true value of intangible assets by those involved with preparation of the accounts and their audit.
- A desire to minimise exposure to amortisation and impairment charges by minimising intangible asset value and maximising goodwill.

To expand on the second point, some intangible assets are deemed to have relatively short lives and are amortised over that life, giving rise to substantial charges to profits. Brands, though, are often deemed to have indefinite lives and therefore have no amortisation. However, the consequence of the indefinite life is a higher risk of impairment and an embarrassing writedown of the brand's value. As brand values have to be tested individually, the risk of impairment is further increased.

Goodwill, on the other hand, does not have to be amortised so there are no charges to profits to explain away. It does have to be tested for impairment but, unlike intangible assets, it can be aggregated into large, sometimes very large, lumps called cash-generating units and these can include parts of the acquirer's existing business. All of this minimises the risk of impairment.

So company managements have significant incentives to leave as much of the purchase price as possible in goodwill.

The limitations of IFRS 3

So it appears that IFRS 3 is not being applied in the ways originally envisaged. In addition, there is no explanation of limitations inherent within IFRS 3 even when it is being applied. The key limitations when reporting under IFRS 3 relating to intangible assets and goodwill are:

- Goodwill brought forward at the date of adoption of IFRS (which is often significant) has been frozen at its brought forward value in all the reports and accounts we looked at. So this figure represents historic goodwill at the dates of pre-IFRS 3 acquisitions (including IFRS 3 intangible asset values not required pre-IFRS 3), less pre-IFRS 3 amortisation, plus post-IFRS 3 goodwill at the dates of acquisitions and less impairment charges. This is such a complicated combination of concepts that the goodwill figures cannot be readily understood, yet the goodwill reported in the accounts is highly significant.

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- There could be charges for impairment where the carrying value of intangible assets is higher than their value. Impairment charges are a highly sensitive area. However, there have generally not been any significant impairment charges in the accounts reviewed and the impairment charges, such as they are, have been ascribed to issues such as a change in strategy.
- Some intangible assets will be stated at their historic valuations and some intangible asset values will be after charges for amortisation and impairment.
- Values of goodwill and intangible assets are stated at historic amounts and have not been revalued.
- Goodwill and intangible assets that have not been acquired will not be shown.
- In revaluing assets there is the question of where such values overlap, as they may be double counted when valued separately (for example, brand and customer relationship values). None of the accounts reviewed refer to this.

So not all intangible assets and goodwill are recorded; what is recorded is at historic cost and not revalued. Goodwill can also be regarded as the difference between market capitalisation and underlying net assets. There is no attempt to explain this, and yet the issue is huge, as illustrated in the chart at the bottom of this page, which shows FTSE 100 market capitalisation-based value against recorded value.

IFRS 3 – the cost/benefit ratio

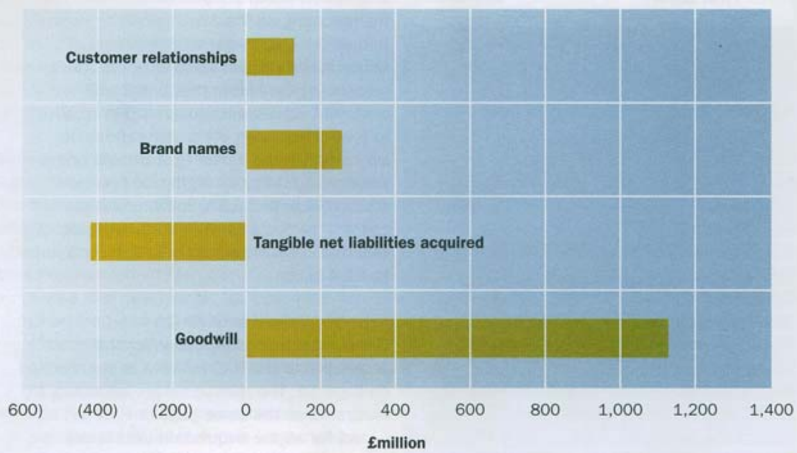
The implementation of International Accounting Standards, and IFRS 3 in particular, has resulted in a great deal of work for the accounting profession. The cost of this for business has been substantial: an estimate of the fees paid by the FTSE 100 companies to the accounting and valuation firms for implementing IFRS 3 could be estimated at 0.2% of deal value, or about £80 million. In addition, it has required significant resources from the companies themselves.

A combination of failing to apply IFRS 3 properly, with no explanations of its limitations, really means that many annual reports and accounts fail to give more transparency on business combinations; in fact, many of the reports are limited, distorted and confused.

So the benefit of the implementation of IFRS3, in terms of disclosing intangible asset value and key related issues, is minimal on the basis of this research. The annual report and accounts have become less relevant as a means of conveying information, as is indicated, for example, by the extent of other communications to investors and stakeholders. The challenge for the accounting profession is now to address some of these shortcomings and to articulate the inherent limitations in the accounts even when complying with IFRS 3. ■

Thayne Forbes is joint managing director of Intangible Business in London

RAC PPA



Aviva acquisition of RAC

Acquirer	**Aviva**	
Acquiree	**RAC 01 May 2005**	
	£m	**£m**
Brand names	260	
Customer relationships	132	
Total intangible assets		392
Other assets		646
		1,038
Other liabilities		(1,064)
Net liabilities acquired		(26)
Goodwill		1,139
Acquisition cost		1,113

FTSE 100 illustration of market cap based value against recorded value