

How IFRSs put brands on the balance sheet



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Together, international financial reporting standards (IFRSs) 1, first time adoption, and 3, business combinations, provide brand-driven quoted companies with a one-off opportunity to put previously acquired brands on the balance sheet. Allan Caldwell explains why such an undertaking might be advantageous, and what it involves.

For branded businesses, the advent of international financial reporting standards (IFRSs) provides a huge one-off opportunity to transform their balance sheets, since one of the key consequences of IFRS3, business combinations, is the recognition of acquired brands on the balance sheets of quoted companies.

IFRS1, first time adoption, allows companies to elect not to apply IFRS3 retrospectively to business combinations prior to their transition to IFRSs. Most companies – not least because of the size of the task of adopting IFRSs generally – may choose to take that election, deciding to apply IFRS3 prospectively. For those companies electing to apply IFRS3 prospectively, brands will only gradually appear on the balance sheet as future business combinations take place.

However, companies whose brands drive their businesses, and who have acquired brands in past business combinations, should consider carefully the benefits of putting those acquired brands onto their balance sheet, by the retrospective application of IFRS3.

As there is only one opportunity to do this retrospective application – on first time adoption, courtesy of IFRS1 – the issue deserves careful consideration before a final decision is made. Having worked on what is probably one of the first such adoptions in the UK, we feel that we can provide some useful insights.

Why are acquired brands now being recognised?
What is the underlying rationale for putting acquired brands, and other

intangibles, on the balance sheet in the first place?

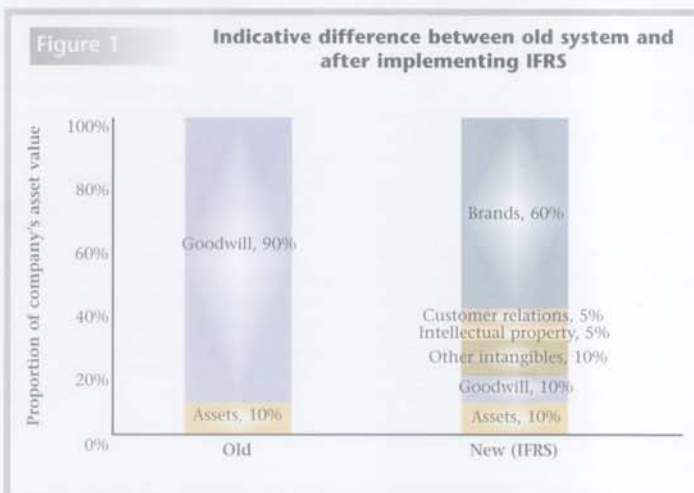
The IASB, in its reasoning accompanying the issue of international accounting standard (IAS) 38, intangible assets, noted that intangible assets were becoming an increasing proportion of the assets of many entities, and pointed to the lead given by Canadian and US standard setters whose view was that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill (see Figure 1, below).

The equivalent US GAAP standard, statement of financial accounting standards (SFAS) 141, is more explicit, stating that ‘users of financial statements also indicated a need for better information about intangible assets

because those assets are an increasingly important economic resource and are an increasing proportion of the assets acquired in many business combinations.’

So, if better information for users of financial statements is a key driver, logically those users would wish to be better informed, not only about future business combinations as and when they arise, but also about those past business combinations that created the company they see today. (Equally logically, those users would also wish to be better informed about the brands that the company has built internally but which continue to be excluded from balance sheet recognition, although that is an argument deserving a separate article.)

For some businesses, the strength of their brands is the key driver of future



profitability and cash flows. Recognising these key assets, at least when they have been acquired in a business combination, will reinforce the message to investors and help them to judge whether those brands are in good health. Investment in brands will become a more important measure when the brands themselves are financially visible. A company that starves its brands of investment to deliver better short term profits will not be rewarded by investors. And while analysts have routinely added back goodwill amortisation to profits as this was a non-cash item, they would do well to pay attention to impairment charges against brand values, as required under IFRS36 (see below), as these will be clear indicators of damage to future cash flows.

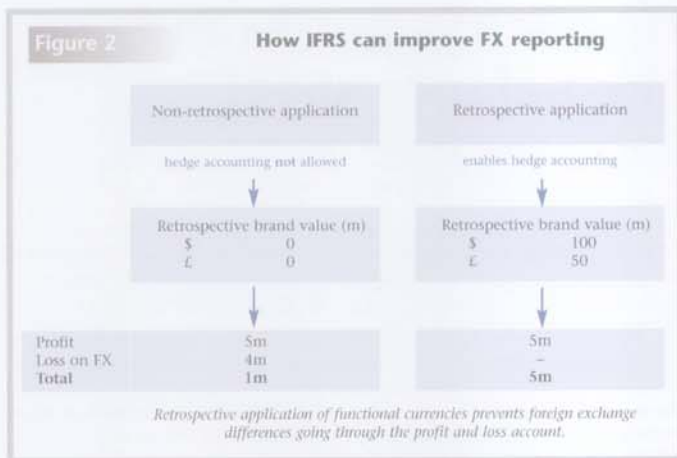
Advantages of reporting brand values

Unfortunately if, as expected, most companies elect not to restate past business combinations, the benefits of reporting acquired brands will only be realised gradually as business structures evolve over many years through future business combinations. We have found, however, that those who perceive the real benefits can accelerate the process by applying the new standards retrospectively to reveal, as far as possible, brands acquired in the past.

Brand driven companies can make a strong statement to the investment community by putting brands on the balance sheet. They can bring themselves into line with competitors who do already report brand values or who are planning to do so, and differentiate themselves from those who don't. Net asset values will increase significantly as brands are recognised for business combinations for which goodwill was originally written off.

A stronger balance sheet will do no harm to credit ratings while, for those grappling with the hedge accounting provisions of IAS39, financial instruments recognition and measurement, recognition of brands may help by creating assets in the currencies which companies seek to hedge (see Figure 2).

Another benefit to those companies which are also listed on a US stock exchange is the opportunity to eliminate some of the differences between UK and US GAAP reporting, where



brands have long been recognised. It would be ironic if, despite all the efforts to achieve convergence between US GAAP and international standards, balance sheets were left with reconciling items for years to come.

Of course, as we have become aware, there are also downsides to having brands on the balance sheet. Poor management will be more readily exposed, if brands become impaired, but isn't that the point of financial reporting? Investors will draw their own conclusions about managements that are silent about their brands, or disclose only the minimum required under the new standards.

Comparability with other companies remains limited, and potentially misleading, as brands are capitalised at historic fair value at the date of acquisition. Brands with similar values today could be reported at widely differing historic values, depending on their date of acquisition.

Retrospective application in practice

Crucially, companies must recognise that retrospective application of IFRS3 can be extremely onerous unless you know what you are doing. The motivation may be the recognition of those all important brands, but the standard must be adopted in full. From the date selected for application, it must be applied to all subsequent business combinations. In addition, IAS36, impairment of assets, and IAS38, intangible assets, must also be applied from the same date.

IFRS1 states that, in relation to business combinations, an entity need not apply certain parts of IAS21, the effects of changes in foreign exchange rates, retrospectively, but if they do not do so, all brands and goodwill recognised under IFRS3 will be in the currency of the acquirer, ie sterling. To get assets into the appropriate currencies, for instance for hedging purposes, it will be necessary to apply IAS21 as well.

However, IFRS1 does give companies an option of setting all cumulative translation adjustments for all foreign operations to zero at the transition date by merging the balance at that date with retained earnings. The same option also allows companies to ignore translation differences when calculating gains or losses arising on the subsequent disposal of a foreign operation.

Application of IFRS3 will require that all the fair value adjustments between UK GAAP and IFRS be identified and quantified, both as at the date of acquisition and in subsequent years. These are likely to be required as a minimum for inventories, post retirement benefits, deferred tax and acquisition provisions, as well as brands and other intangible assets.

Companies already reporting under US GAAP will be pleased to hear that the IFRS fair value adjustments are, in the main, very similar to those required for US GAAP. These fair value adjustments must all be tracked in the appropriate functional currency for each acquisition and translated into

sterling following the provisions of IAS21, assuming that the company elects to apply this standard as well.

Brands themselves must be valued as at the date of acquisition, on a fair value basis without the benefit of hindsight. In practice, this means adopting one of a number of valuation models based on multiples, royalty rates for comparable brands, or discounted future cash flows. The difficulty is not in building the model, but the availability of data from the time of the business combination, so that the valuation can be made without the benefit of hindsight.

One further consequence of IFRS3 is the prohibition of merger accounting. A prior transaction accounted for at the same time as a merger would clearly involve a restatement involving much more than separation of brands and intangible assets from goodwill.

Think hard before passing up the opportunity

Impairment testing

The required retrospective application of IAS36, impairment of assets, alongside IFRS3 is a major issue. For brands, assuming indefinite lives and therefore no amortisation, impairment testing is required. However, IAS36 does permit the reversal of any impairment of a brand if the test in a subsequent year shows the value to have recovered (but only up to the amount originally capitalised). Arguably it is therefore sufficient to test the values of brands for impairment at the date of transition to IFRS.

However, this is not the case for the residual goodwill. IAS36 expressly prohibits the reversal of any impairment of goodwill and it is therefore necessary to test goodwill for impairment at each balance sheet date from the date of first chosen application of IFRS3 up to the transition date.

In practice, testing goodwill impairment requires first the identification of appropriate cash generating units, or groups of cash generating units where these share the synergies arising from the business combination. The total of the net assets, including the brands and goodwill, of each unit is compared with the estimated fair value of the unit, which is normally calculated on a

pre-tax discounted future cash flow basis.

The key point here is that the future cash flows must be forecast as at the testing date without the benefit of hindsight. In practice, this means using strategic plans and budgets prepared at the time. Finding this documentation may be a challenge to companies' archiving systems, depending how far back companies seek to go...

How far back to go?

How far back a company goes in restating prior business combinations will inevitably depend on circumstances, history and, not least, on the information available on past acquisitions. A company that has been transformed in recent years with a series of acquisitions should consider restating all of those acquisitions.

At the other end of the spectrum, a company with one or a few relatively minor recent acquisitions, will probably judge it unnecessary to restate any acquisitions prior to its transition date. Frequently, companies will be limited in practice by the adequacy of their archiving systems and their ability to retrieve contemporaneous strategic plan and budget information to support the onerous goodwill impairment testing requirements of IAS36.

Conclusion

In practice, there are considerable obstacles to companies' abilities to restate and significant costs required to provide the resources and expertise to do it properly and to the satisfaction of their auditors. In our experience, the existence and availability of adequate historic information, especially that necessary to make the fair value adjustments on acquisition and the forecast cash flows required for goodwill impairment testing, will limit the extent to which IFRS3 can be applied retrospectively.

Nevertheless, reporting brands provides more meaningful information, rather than having a significant goodwill figure incorporating the intangibles. Chief executives and finance directors should think hard before they pass up the opportunity to do so: they won't get another one. **F&M**

For more about IFRS3, see page 14.

CPD

What has this got to do with me?

The new continuing professional development (CPD) scheme comes into effect in January 2005 and will apply to members in business. In the first of a series of articles, we give you a brief overview of the scheme.

The Institute's scheme and its requirements are changing. CPD is being extended across our entire membership, including those of you working in business. The new scheme takes a broader and more fundamental view of CPD in seeking to promote professional development and the reputation of our membership. It is also an opportunity for us to engage with you and to provide valued professional development and support services.

The practicalities

The big question is usually 'what is it I need to do?' Simply put, you will be required to provide the Institute with an annual declaration affirming that you have reflected on your responsibilities, undertaken appropriate development activities and considered the impact of those activities, on an ongoing basis.

The first declaration will be due in November 2005 but you should be looking to commence the process of 'reflect, act and impact' from January 2005. Your declaration slip will be sent to you with your 2006 annual subscription pack or you may declare via the web site. Incidentally, the declaration does not mean you will be asked to send in a CPD record.

Key dates for your diary

- The new scheme starts on 1 January 2005.
- You will be sent an information booklet in January.
- First declarations in November 2005; member reviews will commence in January 2006.

More information

More detailed articles will follow in subsequent issues. You will also be able to find more information at www.icaew.co.uk/newcpd. Or else, contact the CPD team on 01908 248293 or e-mail newcpd@icaew.co.uk. **F&M**