Accounting for Intangibles: A Checklist

A checklist for the reporting of acquired intangible assets

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Contents

Accounting for Intangibles: A Checklist

1. Introduction

Accounting for acquired intangible assets can be a minefield. There are financial authorities to satisfy, auditors to convince, standards to comply with, updates, revisions, exposure drafts and international variances to negotiate. The business ramifications can be significant.

"There is a need for improved compliance"

Accounting for intangibles has never been more topical, especially as M&A activity is set to increase. The Financial Reporting Review Panel (FRRP) can name and shame individual companies for their failure to adequately report and for the first time last year it did so for a company failing to identify intangibles. The Financial Reporting Council (FRC) is also targeting accounting for intangibles. In January 2010, it published a study into how 20 listed companies accounted for acquisitions, 'FRC Study, Accounting for Acquisitions'. It concluded that 'overall, the results were disappointing' and that there 'is a need for improved compliance'. It wants directors to consider accounting for acquisitions more carefully and flagged that the revised IFRS 3 should lead to a step change in the recording of intangible assets.

"The FRRP can name and shame individual companies"

To counterbalance this many users of accounts find IFRS 3 to be uninformative.

Intangible Business is highly experienced in valuing intangible assets for compliance purposes. 'Accounting for Intangibles: A Checklist' is designed to outline the key issues involved and answer the most common questions we are asked and issues encountered.

Accounting for Intangibles: A Checklist

2. Relevant standards

Introduction

International accounting standards are issued by the International Accounting Standards Board (IASB), an independent standard setter which aims to develop and promote a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs). There are currently eight IFRSs and twenty-nine International Accounting Standards (IASs).

Navigating the standards to avoid falling foul of regulator disapproval and to ensure a swift audit sign-off whilst still promoting the company's best interests can be a tricky business. A degree of interpretation is still required whilst implementing these standards. All these standards are likely to be first reported in the next year or so and therefore, with a lack of precedent, will require even closer attention. The selection of standards below consists of the most relevant standards for accounting for goodwill and intangible assets on acquisition.

IFRS 3, Business Combinations

IFRS 3 was initially introduced in 2004. The latest revision was issued in January 2008, for periods beginning on or after 1 July 2009. It requires companies to recognise the underlying assets acquired and liabilities assumed at fair value at the date of acquisition. Sufficient information must also be disclosed to enable users to evaluate the nature and financial effects of the acquisition. IFRS 3's objective is to improve the transparency of acquisition reporting.

"..improve transparency of acquisition reporting"

The standard covers asset recognition conditions, measurement principles, treatment of goodwill and contingent liabilities. One of the key inclusions is the requirement to recognise measureable and identifiable intangible assets separately from goodwill. The nature of the goodwill arising from the purchase price allocation must also be disclosed and explained.

IFRS 8, Operating Segments

IFRS 8, Operating Segments was initially issued in 2006. The latest revision was issued in December 2008, effective from January 2009. It sets out requirements for disclosing information about an entity's operating segments and also about the entity's products and services, the geographical areas in which it operates, and its major customers.

The standard covers definitions of operating segments, quantitative thresholds, information disclosure requirements, measurement criteria and reconciliation requirements.

Accounting for Intangibles: A Checklist

IAS 1, Presentation of Financial Statements

The latest version of IAS 1, Presentation of Financial Statements was issued in 2008, effective from January 2009. It sets overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. Its purpose is to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities.

"To ensure comparability"

The standard includes information on the presentation of financial statements, frequency of reporting, materiality, comparative and consistency of information, structure and content, current/non-current distinctions and how the notes should be structured.

Of particular relevance is the need to disclose information about assumptions which management makes about the future that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next year.

IAS 36, Impairment of Assets

The latest version of IAS 36, Impairment of Assets was issued in 2008, effective from January 2009. Its objective is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amounts. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the standard requires the entity to recognise an impairment loss. The standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.

"To ensure assets are carried at no more then their recoverable amounts"

The standard includes information on identifying an impaired asset, how to measure an impairment loss, information on fair value, the basis and composition for estimates of future cash flows, details on foreign currency and discount rates, cash generating units, goodwill and impairment testing.

IAS 38, Intangible Assets

IAS 38, Intangible Assets was first issued in 1998. The latest version was issued in 2008, effective from January 2009. Its objective is to set out requirements for accounting for intangible assets and recognition, measurement and disclosure criteria.

"Requirements for intangible assets"

The standard covers definition of intangible assets, identification criteria, recognition and measurement information, fair value definitions, treatment of internally generated intangible assets and goodwill, details on useful lives, residual value and appropriate amortisation periods.

Accounting for Intangibles: A Checklist

3. Checklist

1. Are there any approved methodologies for valuing intangibles?

There are many methods of valuing intangible assets. Generally a few are used to determine a range from which the most appropriate is selected. IAS 38 references a few of these:

- Where an active market for intangible assets exists, such as taxi or fishing licenses, the most reliable approach is to benchmark value against current bid prices for a similar asset, failing this then the price of recent similar transactions should be used.

- If no active market for an intangible asset exists – which is more common as many are unique – its fair value can be determined using a range of other methodologies, including: market transaction multiples such as revenue, market shares and operating profit; royalty streams that could be obtained from licensing the intangible asset to a third party, such as in the relief-from-royalty approach; discounting estimated future net cash flows from the asset; or other techniques which reflect current transactions practices in the industry to which the assets belongs.

“There are many methods of valuing intangible assets”

There are various valuation bodies, such as the International Valuation Standards Council (IVSC), who have issued various publications relating to valuation for reporting standards.

2. Can I do the valuations internally?

Yes, although the IASC Foundation Education supports the engagement of external advisers, saying: ‘The accounting for business combinations is complex and requires valuation expertise. Even though IFRS 3 does not mandate the use of external advisers, many acquirers will need to seek professional assistance to account for a business combination.’ Using external valuation advisors can smooth the valuation process, bring additional commercial benefits and assist with audit approval.

“Complex and requires valuation expertise”

Experienced valuers can also spot and value intangibles that others might not identify. IFRS 3 (2004) had a requirement that the fair value of an intangible asset had to be capable of reliable measurement if it was to be recognized. IFRS 3 (revised) concludes that all intangible assets should be capable of reliable measurement when acquired as part of a business combination and, hence, there is no longer any test of reliable measurement that is required to be passed. The FRC believes that ‘This should lead to a step change in the recording of intangible assets in future audited accounts’.

Accounting for Intangibles: A Checklist

3. What is the best way to communicate results to stakeholders?

IFRS 3 and IAS 1 require companies to disclose information in such a way as to enable users of the financial statements to evaluate the nature and financial effects of the business combination and ensure comparability with both the entity's financial statements of previous periods and those of other entities. The annual report is the best place to communicate to stakeholders with clear information; in the business review/management commentary, financial statements and notes to the accounts. The recent FRC study of accounting for acquisitions found that many companies are failing to link the rationale for an acquisition given in the narrative with the detail in the audited accounts.

"The annual report is the best place"

Additionally, inclusion of further detailed information can be included in investor and analyst presentations and marketing communications where relevant and made available to all through a company's website. The approach should be to focus on communication and not just meeting the minimum compliance. Given that many users of accounts find the treatment of IFRS 3 not useful this presents a particular challenge.

4. How can I best manage CGU issues?

The standard does allow individual assets to be grouped into Cash Generating Units or CGUs with the impairment review then covering the CGU as a whole. Other things being equal, a reduced number of broader CGUs can:

- Manage the risk of impairment loss by the portfolio effect
- Cushion the risk of impairment loss if the CGU also contains unrecognised internally generated intangible assets
- Lessen what can be an onerous annual task of preparing detailed discounted cash flows
- Reduce audit fees
- Allow management time to be focused on value-adding activity

"Companies will need to take care"

The standard does however set some constraints on which assets can be grouped into CGUs. In particular, that the recoverable value of the individual asset cannot be determined – for example, if it does not generate cash flows that are largely independent of cash flows from the other assets in the CGU.

The standard also links with IFRS 8, Operating Segments which requires the segments to be determined 'through the eyes of management'. Companies will need to take care to assess the interaction between IFRS 8 and IAS 36.

Accounting for Intangibles: A Checklist

5. How can I avoid double counting asset values?

When accounting for business combinations under IFRS 3, it is important to be aware of issues of double counting asset values in a way which could unduly affect future profitability.

Inventory step-up is a prime example and can be an expensive headache. Typically, inventory is accounted for at cost. On acquisition, IFRS 3 states that the inventory price should be stepped-up to fair value, or what it can be sold for.

Inventory step-up issues impact most business acquisitions and most types of inventory, from clothing to pharmaceuticals, fragrance to engineering. It is particularly marked in the spirits industry where the margins are high, brands play a very important role and the inventory is often laid down for many years. For example, if the cost of a bottle of whisky in the balance sheet is at £5 per bottle, the value it would sell for could be about £20. An IFRS 3 implementation might value each bottle at £20 meaning its new owner would lose the opportunity to make £15 per bottle, effectively making no profit whatsoever for many years.

"Be aware of issues of double counting asset values"

This value of the inventory, however, is double counting the brand value, which is valued elsewhere. As well as the brand, the difference between cost price and its fair value often includes other assets also valued elsewhere. These issues are key to understanding an appropriate level of step-up for the inventory which would be a lot lower than £15.

Property valuations also often include a brand valuation. For example, when a property-based business such as a care home, hotel or shop is valued, it is generally valued on an ongoing business basis. This property valuation therefore assumes the use of other assets beyond simply the bricks and mortar, such as the brand, workforce, customer relationships and contracts.

6. How do I ensure efficient tax management?

Tax benefits might be gained through the appropriate use of a Special Purpose Vehicle (SPV). Inevitably, consideration needs to be given to the location where the intellectual property (IP) is to be transferred to. In other words, the anti-avoidance provisions that could apply to the income derived from the intangibles. Therefore, the re-organisation of any business IP should focus on the commercial and fiscal aspects.

Moving IP into a separate company could increase shareholder value in a number of ways. It can ring-fence assets so they are no longer vulnerable to other business risks. It tidies up ownership of the intangible assets, ensuring they are owned properly, looked after and given the attention they deserve as highly valuable business assets. It draws together all the legal and commercial activities required to manage IP. Another key commercial benefit is it focuses management attention on the asset as business divisions or fellow subsidiaries will need to pay for its use at arm's-length rates.

"Focus on the commercial and fiscal aspects"

The following types of intangible assets are amongst those that could be considered: brand names; mastheads and publishing titles; computer software; licenses and franchises, copyrights, patents and other industrial property rights, service and operating rights; contracts and databases; recipes, formulae, models, designs and prototypes; and intangible assets under development. The more significant and reliable the cash flows generated by the asset the more suitable they are. Brand names, for instance, are often suitable as they are frequently the most valuable asset with significant cash flows attached.

Accounting for Intangibles: A Checklist

7. What are the key IFRS 3 disclosures I need to make?

The FRC's recent study of Accounting for Acquisitions highlighted a number of areas it is concerned over.

IFRS 3 requires disclosure in the audited accounts of '…information that enables users… to evaluate the nature and financial effect of business combination…during the period…' The FRC suggested companies need to better link the explanations of the rationale for their material acquisitions set out in their business review with the information provided in the audited accounts.

"Need to better link rationale for acquisitions to information in accounts"

IFRS 3 requires intangibles to be recorded separately if they are identifiable (i.e. contractually or legally secured or are separable from the business). The FRRP recently criticised Brewin Dolphin for not separately recording intangible assets. Similarly the recent FRC review referred to two of the 20 companies reviewed having recorded no intangible assets despite highlighting several intangible benefits in their business review.

IFRS 3 requires companies to disclose the amounts recognised for each class of assets acquired in each material acquisition. The FRC was disappointed to find seven of the 20 companies reviewed had aggregated intangibles from a number of material acquisitions and thus failed to comply.

IFRS 3 requires companies to disclose separately each material class of asset they have acquired in each material business combination. The FRC notes that the practical effect of this requirement is that companies need to describe the nature of the individual intangibles they have grouped together. Its study suggests companies are struggling to establish meaningful groups.

IFRS 3 requires a 'qualitative description of the factors that make up the goodwill recognised'. The FRC study found that six of the 20 companies reviewed failed to provide the required disclosure and that none of the rest provided descriptions that 'were genuinely informative'.

8. What is the best approach to IAS 36 impairment reviews?

A sensible approach is to prepare for these at the time the initial valuation for IFRS 3 is taking place. It is also a good discipline for the sensitivity analysis, required by IAS 36 to determine the key assumptions, to be deployed at the earliest stage possible. The decision on which and how many cash generating units to have can have a critical bearing on the impairment reviews (see 4. above).

"Prepare at the time of the initial IFRS 3 valuation"

Ideally, there should be a consistency of approach, assumptions and modelling across the initial acquisition financial proposal, the IFRS 3 valuation and the impairment review. Those assets – typically brands - deemed to have an indefinite useful life are required to be tested each year (at any time in the annual period but then at the same time every year). It is good practice to have a framework of impairment indicators – external and internal – that can be then be routinely collected and monitored.

Although an impairment loss is a non-cash item it can still send very strong messages – particularly if associated with a recent acquisition which might bring management's judgement into question. Therefore the communication of an impairment loss to investors, analysts and the media needs careful consideration and planning.

Accounting for Intangibles: A Checklist

9. What are the key impairment disclosures I need to make?

Detailed disclosure requirements are set out in paragraphs 126 to 134 of IAS 36 and include:

- Extensive disclosures about impairment losses recognised in the period including the events and circumstances that led to the impairment
- Detailed disclosure of the key assumptions used in the valuations including time periods, growth rates and discount rates
- A description of management's approach to determining the key assumptions and whether they are consistent with past experience and/or external information and, if not, how and why they differ
- Justification for using any growth rate that exceeds the long-term average growth rate for the products, industries or countries in which the entity operates in or markets to.

There is a requirement for additional disclosures under paragraph 134 f) if a 'reasonably possible change' in a key assumption would have caused impairment. These disclosures include the amount by which the recoverable amount exceeded the carrying amount, the value assigned to the key assumption, how much the key assumption needs to change for recoverable amount to be equal to the carrying amount.

"Key disclosures include: impairment losses, assumptions, approach and justification for growth rate"

What is not always appreciated is there is an earlier alarm bell disclosure in IAS1 paragraph 116. This requires disclosure of information about key assumptions and uncertainty that have a 'significant risk' of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year. This reflects the experience that impairment reviews tend to be reflected in the accounts rather later than they could have been. It should also be appreciated that making an impairment provision is a significant event, not least as it can represent management's view of the value of that part of the business.

The FRC published a review of goodwill impairment disclosure in October 2008 and out of 32 companies analysed, disclosure by six was deemed 'very useful', by nine 'useful' and by 17 'boiler plate – rather uninformative'. It concluded that the results demonstrated that there was an opportunity for companies to refine their goodwill disclosures – particularly in the light of the harsh economic environment.

10. How do I ensure audit sign-off?

Planning meetings should take place well in advance of the period end to enable management to explain the approach being taken to the upcoming impairment review. At the very least this should explain how management is approaching the determination of the assumptions that require disclosure under IAS 36 such as time periods for cash flows, growth rates and discount rates. The meetings should also cover the internal and external indicators that are being monitored in relation to impairment testing. It is also critical that the finance and accounting team keep management and the audit committee fully appraised of what the risks of impairment are – not least because if there are 'significant risks' they may fall to be disclosed at an early stage under IAS 1. The underlying philosophy should be 'no surprises'.

"No surprises"

It will also help if the auditors are taken through the modelling approach 'off-line' from the audit process. This will enable the discussions in the audit to focus on the determination and value of the key assumptions (defined under IAS 36 as those to which the recoverable amount is most sensitive).

In terms of interpretation of standards one should refer back to the original standard because otherwise there is a risk that auditor interpretations can become a quasi standard. This could, for example, occur in the context of CGUs and inventory step-up.

Using an independent valuation firm, as the IASC Education Foundation advises, can also assist the audit sign-off process as the valuations can be seen as more objective, more robust and the valuation firm can help mediate between client and auditor to avoid potential conflicts or confrontations that can occur.

Accounting for Intangibles: A Checklist

4. Conclusion

The issues included here are just a selection, highlighting the importance and complexity of accounting for intangibles. Valued properly by a specialist such as Intangible Business, accounting for intangibles post acquisition can lead to many commercial benefits, including:

- Avoiding potential conflicts with regulators
- Ensuring a smooth audit sign-off
- Reducing costs through an efficient valuation and reporting process
- Streamlining ongoing impairment reviews
- Increasing earnings through inventory step-up, CGU reporting and impairment risk issues
- Increasing efficiencies via IP restructuring, tax management and transfer pricing
- Effective communication of the benefits of an acquisition in line with the narrative

“Many commercial benefits”

IFRS 3 has been with us since 2004 but it is evident both from our own research and most recently by the FRC study that most companies are simply not making the grade and the FRRP is on the case. But it’s not just about compliance. As the FRC study demonstrated there is often a very good rationale in the narrative that is not backed up by the identification of intangible assets in the audited accounts. This is about communication of the benefits of an acquisition which merits more attention and diligence than it has in the past.

“Companies are simply not making the grade and the FRRP is on the case”

Also the revised IFRS 3 has only been with us since periods beginning on or after 1 July 2009. A subtle but important change lies within. As the FRC has flagged the conclusion that all intangible assets are measurable, this should, in their view, ‘lead to a step-change in the recording of intangible assets in audited accounts’. This is also about communication and investors will expect improvements in the quality of reporting and the FRC will monitor their reaction over the next 18 months.

Lastly, as the impact of the recession spreads to other sectors many management teams will have to consider whether to make impairment losses at the year-end or disclose the ‘reasonably possible’ sensitivity under IAS 36 or the ‘significant risks’ of write-down in the next financial year under IAS 1.

Overall, accounting for intangibles need not just be seen as a technical implementation exercise conforming to a range of complicated standards. Experienced valuers will be able to extract commercial and management benefits from the process whilst ensuring a quick and effective compliance.

Intangible Business

Intangible Business is the world's leading independent intangible asset valuation consultancy, specialising in valuing intangible assets for financial, banking, management and litigation purposes.

For further information and enquiries, please contact William Grobel or Thayne Forbes:

Intangible Business Ltd.
9 Maltings Place
169 Tower Bridge Road
London
SE1 3JB

Tel: + 44 (0) 20 7089 9236
Fax: +44 (0) 20 7089 9239

Registered in England & Wales Company Number 4193941

www.**intangiblebusiness**.com