*thought***pieces**

Incisive analysis of topical issues

INTANGIBLE BUSINESS

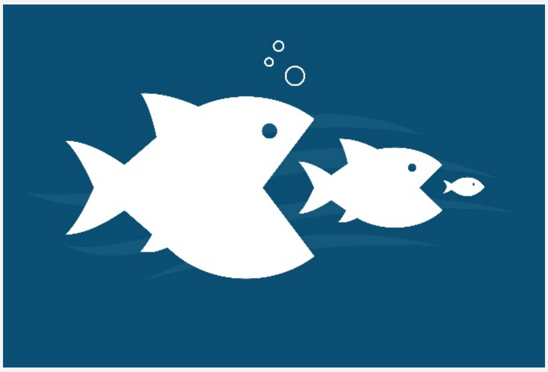
October 2021

Accounting for business acquisitions

About this issue

This issue is based on experience we have gained from valuations of brands, intellectual property (IP), intangible assets and businesses over the last 30 years. It also reflects the views of others involved in the mergers and acquisitions markets.

We have a background of working for professional consulting firms and businesses rich in intangible assets. Our specific skills and knowledge are in the fields of global business development, accountancy, finance, marketing, valuation and dispute resolution.



Introduction

It might be an afterthought, but formal accounting for business acquisitions in practice has always had a significant effect on reported profits and assets. This thoughtpiece looks at accounting for the value of intangible assets in the context of business acquisitions. This has become increasingly significant, as intangible assets often make up the bulk of the value of acquired businesses and recent business acquisition activity has been relatively high. And there are many new factors impacting recent reporting, such as COVID-19, Brexit, and supply chain problems. These will impact anticipated cash flows and associated risks, and therefore asset values, arising from business acquisitions in new ways.

Over the last 20 years, accounting for business acquisitions has developed into one of the few areas of corporate reporting which give statements of asset value. Another commonly found, and significant, area is reporting on the value of land and buildings. For intangible assets, governing US, international and local Generally Accepted Accounting Principles (GAAP) have generally converged. Overall, they require fair values to be given to intangible assets acquired, and to rationalise residual intangible assets (goodwill). There are some minor differences between different GAAP, such as where UK GAAP requires intangible assets to have finite anticipated commercial lives but international GAAP allows for indefinite lives.

Intangible assets are often the bulk of business value

Significant amounts attributed to intangible assets and goodwill are often seen in practice, and this has been the case for many years. Below is a diagram of an acquisition 15 years ago where we valued the intangible assets on what might have been thought to be a tangible asset rich business. But, as can be seen, most of the value actually resided in intangible assets and goodwill:

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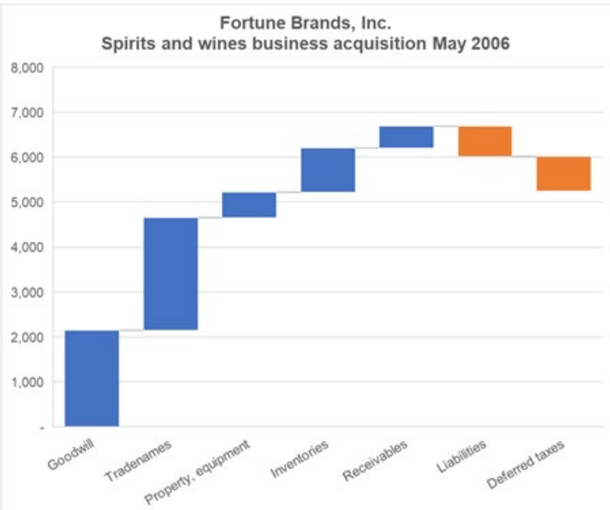
Spirits & Wine



Source: page 72 of Fortune Brands Inc 10-K for 2006

Once intangible assets are recognised and capitalised there is then a need to consider subsequent impairment reviews. These are aimed at ascertaining whether any diminution in value, compared with the carrying value, has occurred, and in such circumstances provisions for impairment might be required. Such provisions imply that asset value has gone down since acquisition, which may not reflect well on management.

Financial reporting council (FRC)

FRC

The FRC is an independent UK regulator which, amongst other things, seeks to ensure that the provision of financial information by public and large private companies complies with relevant reporting requirements. The FRC reviews the directors' reports and accounts of public and large private companies for compliance with the law. It also keeps under review interim reports of all listed issuers and annual reports of certain other non-corporate listed entities.

When carrying out such reviews, the FRC looks more at disclosure, rather than calculations of amounts actually quantified in financial statements. The FRC has fairly recently (April 2019) carried out a review on accounting for intangible assets, and its overall summary is consistent with what we have seen in practice:

"We found numerous instances of good practice across each aspect of disclosure – events and circumstances triggering an impairment loss, description of cash generating units, key assumptions used to estimate the recoverable amount, and sensitivity analysis. However, no company stood out as clearly providing fully compliant disclosures in all relevant areas. Alongside instances of good practice, we also identified a number of common disclosure omissions and opportunities to clarify and enhance disclosures, particularly around sensitivity and significant judgements and estimates. It is also the case that intangible assets now often comprise the bulk of acquisition prices. In practice the key components of this usually are brand, customer relations, people, synergies and residual goodwill."

Source: page 5 of FRC Thematic Review October 2019

It is clear that the FRC requires improvement in financial reporting on acquisitions

Auditing intangible asset valuations

Intangible asset valuations arising from acquisitions need to be audited if they are to be included in audited financial statements. Key elements of the scope of such audit work are likely to be based on the following:

a. Determination of the present value of any contingent or deferred consideration.

b. Identification of intangible assets.

c. Valuation methodologies applied to value identified intangible assets.

d. The composition of, and assumptions for, underlying cash flows adopted.

e. Key inputs of the valuation approaches. For example discount rates, royalty rates where a relief-from-royalty method is used, or contributory asset charges (fixed assets, working capital, workforce or other intangible assets) where an incremental earnings methodology is employed.

f. Modelling accuracy, for example that cash flows are correctly composed and linked, discounting formulae are correct, tax amortisation benefits are incorporated correctly, and arithmetic is correct.

g. Useful economic lives of intangible assets.

h. Valuation cross-checks adopted in order to determine if the valuations are reasonable. This would include cross-checks on the valuation conclusions such as comparisons with other transactions, a Weighted Average Return on Assets (WARA), and qualitative consideration of goodwill components.

i. Level of documentation. This will include the sufficiency of documented support for identification of assets, valuation methodologies and key assumptions, schedules and cross-checks, size and components of residual goodwill balances.

In the current environment, auditors will generally only audit intangible asset valuation work on business acquisitions on which they are reporting, and will not carry out such valuations themselves.

An example of a potentially significant issue raised by auditors, where we were involved, was on the acquisition of an aged spirits brand by an international drinks company. The acquired business had significant amounts of aged inventory and the auditors questioned whether these should be valued at their sales value less costs to sell. If adopted this would have meant that the acquired business would have shown no profits for many years after the acquisition. We went back to the standard, IFRS 3, and successfully argued that the costs of the intangible assets, including brand, should also be considered when valuing inventory. This was accepted by management and the auditors with the result that the acquired business would then report commercial levels of profits after acquisition.

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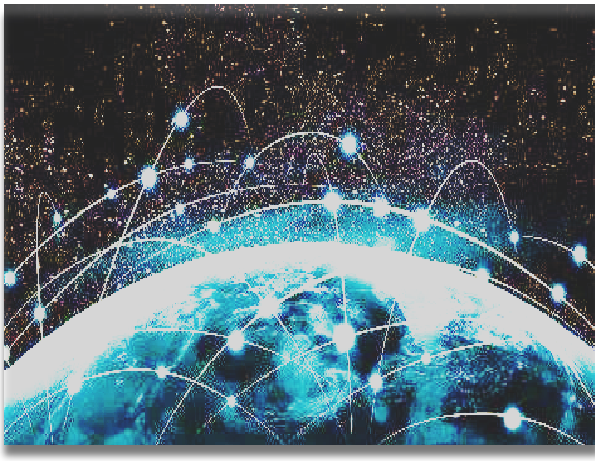
International Valuation Standards Council (IVSC)

Accounting standards are issued by standard setters such as the International Accounting Standards Board. However, where accounting standards require valuations then reference is now more often made to the valuation standards issued by the IVSC.

The IVSC have just initiated a discussion about valuing intangible assets: Time to get Tangible about Intangibles. This notes that, despite the importance of intangible assets to the capital markets, only a small percentage are recognised on balance sheets. As many current business models have evolved over decades, to rely more heavily on intangible assets, the standards to report on such activities have not. As a result, the economics and the reporting standards have become misaligned.

At this stage there is a desire for more information which a reader of the accounts could use to form their own views on the values of intangible assets. The thinking is that, subject to commercial sensitivities, the disclosure of such information could lead to greater confidence in companies which would be reflected in higher share prices.

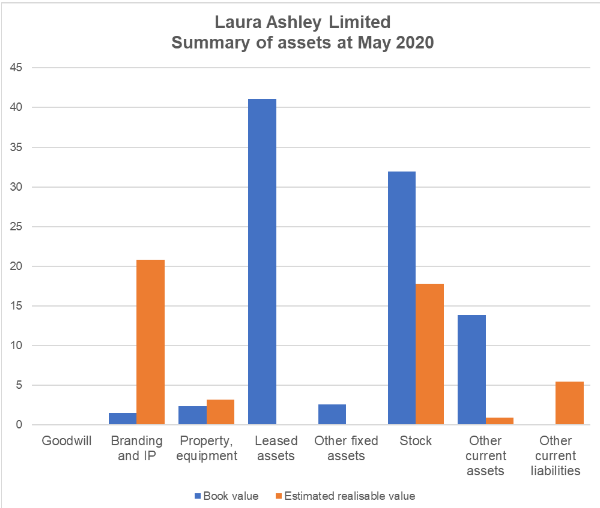


There can be significant intangible asset value in insolvency

Insolvency

LAURA ASHLEY

Some administrations of companies, such as Laura Ashley in 2021, have highlighted that brands can be key valuable assets to companies in financial distress, and that values realised in administration bear little resemblance to amounts in the balance sheet. Below is a diagram of the estimated realisable values of Laura Ashley's assets, compared with book values, after entering administration:



Source: page 6 of Laura Ashley Limited statement of affairs 5 May 2020

It is clear that the Laura Ashley brand was a key asset in the circumstances of corporate insolvency.

Conclusion

Some view such work from a compliance perspective, that it is a cost of reporting under current reporting standards. We firmly believe, however, that there are benefits to be had from carrying out such intangible asset valuations properly and taking them fully on board as meaningful areas of financial reporting. This, in itself, will lead to better compliance with the reporting standards. It is not an area that should be marginalised, and good financial disclosure gives useful information and improves the transparency of acquisition accounting.

There are also opportunities to disclose additional information on the values of intangible assets as well as complying with formal accounting standards, for example in accompanying reports. This should help to cement intangible asset value in return for giving information readers would like to have.

We have experience of doing such intangible valuation work regularly over the last 20 years, together with providing balance sheets on acquisition, and have had our work audited by all of the major audit firms. We do not carry out audits and therefore have no conflicts from that perspective.

Valuation services offered by Intangible Business:

Our valuation services are based on professional and commercial knowledge and experience in accounting, marketing, investment banking, and research. We provide:

Analysis and opinions on:

- Business value.
- Brand, intangible asset and intellectual property value.
- Share value.
- Historic and forecast profits.
- Related revenues and costs.

Support in connection with:

- Business development, acquisitions, disposals, licensing and franchising.
- Financing and lending.
- For information, so that values of critical assets are measured and managed.
- Dispute resolution.
- Accounting for acquisitions and impairment.

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Thayne is a qualified accountant and marketer who has worked in consulting firms on valuation, dispute resolution and other special assignments since 1988. Thayne specialises in advising on all types of intangible asset valuation resolution projects on a range of issues across many different industries.

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Stuart is a qualified accountant and marketer who has 20 years of commercial experience with Reed International, Haliburton, Sea Land and Allied Domecq. Since 2000 Stuart has also focussed on all types of intangible asset valuation projects and has particular experience in the global beverages industry.

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