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# SPECIAL FOCUS CHAPTER

## Reporting the value of acquired intangible assets

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# Reporting the value of acquired intangible assets

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According to recent PricewaterhouseCoopers' analysis of the US market, intangible assets and goodwill constituted 74 per cent of the average purchase price of acquired companies in 2003 (with, respectively, intangible assets representing 22 per cent and residual goodwill 52 per cent). These findings are certainly in tune with the increasing attention now being paid to the management of intangible assets by companies in the US and worldwide – and the growing demand from investors, analysts and standard setters for the provision of accurate, properly communicated information on the value of companies' intangible assets. Most recently, this has presented itself as a live strategic business issue in the wake of the March 2004 introduction of the International Financial Reporting Standard for Business Combinations (IFRS 3). Requiring companies to report the value of any intangibles forming part of an acquisition/business combination (defined as the 'bringing together of separate reporting entities into one reporting entity'), IFRS 3 puts intangible asset value management squarely on the map as a core management issue by imposing this mandatory reporting requirement on all companies reporting under IFRS.

Partly driven by recent high-profile reporting-related scandals, accounting bodies around the world have been steadily shifting financial reporting to more of a fair value/mark to market basis. As part of this shift, there has been a significant and steady change in the accounting for business combinations, specifically in the area of the treatment of intangible assets. Intended to introduce increased transparency into business acquisitions, this trend – led by the summer 2001 introduction in the US of similar standards FAS 141 (Business Combinations) and FAS 142 (Goodwill and Other Intangible Assets) – reflects the fact that acquisition prices are frequently considerably in excess of the value of the net tangible assets acquired and it is questionable to call all of this balance goodwill when typically it is represented by other intangible assets capable of reliable measurement.

## Brave new world?

The newly introduced IFRS 3 is a very significant extension of this shift to enhanced transparency. Its impact should not be underestimated. All EU companies on listed exchanges will be required to report under IFRS from 2005 and, at the same time, many other countries including, for example, Australia, are also adopting these same standards. IFRS is therefore becoming the new accepted language for financial reporting. There are also significant pressures to converge the US and International Financial Reporting Standards to establish one set of global standards.

### Principal changes of IFRS 3 at a glance

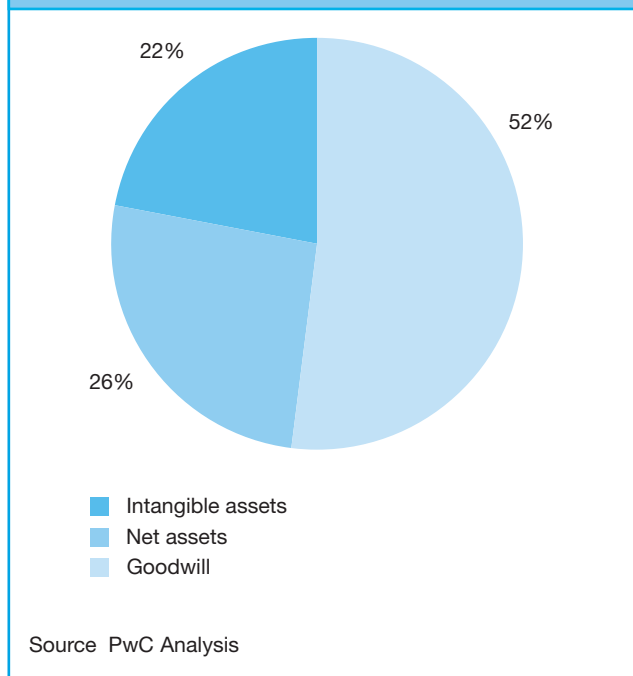
- All business combinations are to be accounted as acquisitions - no more merger accounting.
- Goodwill is no longer amortised but subject to rigorous annual impairment tests.
- More intangible assets will be identified, valued and recognised on acquisition.
- Detailed disclosures about transactions and impairment testing are required.

Where accounting for intangible assets is concerned, a major problem until now has been that, while there is more or less global consensus that accounting for IP is an issue that demands attention, there has been less agreement on how these assets should be recognised and accounted for. This means that the same company's balance sheet can look completely different under different jurisdictions' accounting rules, notwithstanding the fact that each purports to show a true and fair view. The additional disclosure now mandated by IFRS 3 means that the market can expect to receive valuable in-depth information, helping them to assess more accurately exactly what companies have acquired. However, it should also be pointed out that, while this is clearly a positive step, a major gap still exists in the reporting of intangible assets because no jurisdiction yet allows a company to place a value on its internally generated intangible assets.

#### Goodwill no longer amortised

One of the most significant changes introduced by IFRS 3 is the fact that intangible assets other than goodwill that are recognised on the balance sheet will either be amortised over their useful life (hitting the profit and loss account and reducing earnings) or, if appropriate, assigned indefinite lives. Assets given an indefinite life will not be amortised, but will have to undergo an annual impairment test. The criteria for indefinite lives are strict, to the extent that few assets can be expected to meet them (see below). IFRS 3 has also changed the rules for residual goodwill. Goodwill is no longer amortised, but is instead subjected to a stringent, annual impairment test. In the event that it is impaired, an immediate charge will be taken to the profit and loss account, so poor-performing acquisitions will be highlighted through such a charge sooner rather than later. This represents a fundamental

Figure 1 Breakdown of average purchase price – 2003



shift in the way goodwill is viewed. Goodwill is seen no longer as a steadily wasting asset, but instead as one that should be expected to maintain its value.

#### No more pooling of assets – the end of merger accounting

Another key provision is the compulsory treatment of all business combinations as purchases – abolishing the choice of using the pooling of assets method (or merger accounting), which allowed companies simply to pool their balance sheets together, thus not recording any goodwill. This development may well have a very significant impact. For example, five of the six big pharma companies underwent defining mergers in the last seven or eight years – and all of them were treated as mergers and not acquisitions.

#### Purchase price allocation (PPA) now required in all cases

Under IFRS 3, recognising acquired intangible assets separately on the balance sheet is to be carried out as part of a purchase price allocation. Before IFRS, the difference between price and book value was goodwill. This goodwill bucket contained, *inter alia*, all the internally generated intangible assets (eg, brands and patents) which had not been capitalised by the acquired company. All these assets will now have to be identified, valued and separately included on the balance sheet. The list of

intangible assets that will have to be separately recognised as a result of IFRS 3 is very extensive (see box). IFRS 3 demands that the identification and valuation of intangible assets should be a rigorous process. Those preparing accounts under these standards should also bear in mind the fact that, under Financial Accounting Standards Board (FASB) Standards 141 and 142, the SEC can, and does, call for the working papers supporting a company's purchase price allocation and underlying valuations, and has the ability to ask for the work to be re-performed if they consider that the requirements have not been complied with. Similar strict implementation is to be expected when companies report under IFRS.

### Impairment reviews

Under IFRS 3, goodwill is no longer deemed to have a finite life and is therefore not amortised. Instead, it is treated as having an indefinite life and is reviewed for impairment at least once a year. Other intangible assets may also be deemed to have indefinite lives, but this is rare and usually limited to certain trademarks. Most intangible assets other than goodwill are amortised over their expected useful lives. Assets given an indefinite life will have to undergo an annual impairment test. Unlike the situation in the US under FAS 141 and 142, the IFRS test is a one-stage process, based on value in use (or value to the current owner), as opposed to the two-stage test in the US which is based on fair or market value. Detailed disclosure will be required in relation to these annual tests including the assumptions underlying the impairment tests and, potentially, how sensitive the result of the impairment review is to a change in any of these assumptions. Therefore, management needs to be aware that shareholders and analysts will have more information to assess acquisitions and ask difficult questions in relation to their post-acquisition performance and the reasonableness of the impairment reviews. Some indication of the likely impact of these impairment tests can be obtained by looking back at the experience of some companies reporting under US GAAP, and being forced to make some significant impairment charges (under FAS 141 and 142). A case in point from the early days of FAS 141 was Telefonica. When the Spanish telecom giant restated its accounts under US GAAP, its originally announced net profit of €2.11 billion under Spanish GAAP turned into a net loss of €7.18 billion. The main reason for this huge difference was the need for writing down goodwill relating to acquisitions (including that of Lycos).

### Useful life

The fact that most intangible assets (other than goodwill) are amortised over their expected useful lives imposes another burden on management – the need to determine the expected useful life of each of the assets acquired. Lining is an important process and management will want to pay careful consideration, particularly to the assets which may be ascribed an indefinite life (ie, the ones which will not be amortised but tested for impairment annually, like goodwill). Brand names are a good case in point. If the brand has been around for ages, enjoys high awareness and is a market leader (eg, a leading soft drinks brand), it will be relatively straightforward to ascribe an indefinite useful life for accounting purposes. Similarly, where last week's latest high-tech gadget is concerned, there will be little difficulty in ascribing a fairly short, finite useful life. Anything in between these two extremes is, however, likely to prove troublesome.

Management should bear in mind that difficulties in accurately determining an intangible asset's useful life do not provide a basis for regarding that useful life as indefinite. Concluding upon a useful life requires careful consideration of the circumstances as well as judgement. An indefinite life assertion needs to be backed by evidence and analysis supporting that no legal, regulatory, contractual, competitive, economic or other factors limit the life of the asset. Examples of such evidence might include internal and external empirical data (eg, lifecycle studies, market, technological and other trends; and renewal and extension patterns), as well as the opinions of valuation and industry experts.

In light of the guidance provided by IFRS 3, it is envisaged that indefinite-lived assets will be rare. It is worth noting that following the introduction in the US of FAS 141, which includes similar guidance on lining issues, the authorities there expressed surprise at the larger-than-expected volume of assets being ascribed indefinite lives.

### Impact on earnings

Goodwill and intangibles constitute a majority proportion of the value of most companies (see PricewaterhouseCoopers research referred to in introductory paragraph). In light of this, there can be absolutely no doubt that the introduction of IFRS 3 is set to have a very real impact on earnings. Under the accounting standards that formerly applied in many countries, a significant proportion of the cost of an acquisition was typically allocated to goodwill, which was then amortised, typically over a period of 20 years. Under IFRS 3, no amortisation of goodwill could lead to a positive short-term effect on earnings. However,

when companies complete deals under the new standard, less of the cost of acquisition will be allocated to goodwill. More intangible assets identified in new transactions, that are amortised over their useful lives, may well result in higher amortisation than if the cost of acquisition had been allocated to goodwill. This is because several of the intangibles typically recognised tend to have lives significantly shorter than goodwill (eg, contractual and non-contractual customer relationships, order backlog, non-compete agreements, software etc). It is therefore likely that, in a number of cases, the acquiring company's earnings will be lower than those expected as a result of identifying, valuing and amortising intangible assets. In addition, impairment charges will inevitably inject more volatility into the market, with the result that earnings are likely to fluctuate more than ever before.

Following the introduction of the US equivalent standard and consequent large impairment changes, management in some cases tried to downplay the significance of goodwill write-downs and pass them off as irrelevant and non-meaningful given that they are non-cash and one-time, blaming them on some obscure accounting change. Indeed, for analysts focusing solely on cash flow, these write-downs should not matter greatly. Also, ironically, these charges clean up the balance sheet and can result in significantly improved return on equity in subsequent years. However, a large charge does indicate to investors that a company has overpaid for an acquisition. Furthermore, large equity depletion may have implications for debt covenants. In addition, EPS, which is directly affected by such charges, is still used widely as a performance indicator and in some cases has an impact on directors' remuneration.

So how can management deal with these issues? It is important that those concerned with policy making and deal structuring are fully aware of the impact of IFRS 3 on the P&L and balance sheet. In many situations, there will be some flexibility in structuring a deal, which can allow for managing this impact, and ensuring that it is consistent with overall corporate strategy. There might, for example, be a trade-off between the level of earnings and the risk of large impairment charges. The higher the combined amount of goodwill and indefinite-lived intangibles, which are treated similarly to goodwill (not amortised) and differently to definite-lived intangibles (amortised over their useful life), the lower the amortisation charge and, thus, the higher the profit. However, having large amounts of goodwill-like assets on the balance sheet increases the risk of impairment.

Before a transaction, decision makers are best advised to

### Examples of intangible assets that will have to be separately recognised as a result of IFRS 3

#### Marketing-related

Trademarks, brands, trade names, trade dress, internet domain names, non-compete agreements.

#### Customer-related

Customer lists, order of production backlog, customer contracts and related relationships, non-contractual customer relationships.

#### Artistic-related

Plays, operas, ballets, books, magazines, newspapers, musical works, pictures, photographs, videos, films, television programmes.

#### Contract-based

Licensing, royalty and standstill agreements, contracts for advertising, construction, management, service or supply, lease agreements, construction permits, franchise agreements, operating and broadcasting rights, use rights such as drilling, water, air, mineral, timber cutting and route authorities, servicing contracts, employment contracts.

#### Technology-based

Patented technology, computer software, unpatented technology, databases, trade secrets.

carry out thorough analyses of the current and projected value of goodwill and intangibles to be acquired, based on the post-merger business plan. At the transaction and PPA stage they need to exercise care, for example when it comes to defining the acquired mix of definite and indefinite-lived intangibles. Post-transaction, implementing a robust IP value measurement and management system would enable management to monitor the value of the intangibles at regular intervals, thus resulting in better performance management – as well as providing an early warning when things go wrong, and allowing for corrective action to be taken.

### IFRS v US GAAP

Although the IASB and the FASB have worked to remove as many of the differences between IFRS and US GAAP as possible, some differences remain. The date of an acquisition under IFRS is the date on which control physically passes (whereas in the US, it is the date on which the agreed deal is announced). Under US GAAP, in-process R&D acquired must be immediately expensed, while under IFRS this asset is capitalised and amortised (assuming certain criteria are met).

Thus, US GAAP profits take a hit immediately following an acquisition, while those under IFRS smooth this over the next few years. And there are key differences, as already described, between the two-stage US impairment test and the one-step process under IFRS 3.

### Forward thinking

IFRS 3 is clearly a positive step, boosting M&A deal transparency and forcing management to take the management of their intangibles more seriously than ever before.

The investment community is likely to penalise companies that fail to address the impact of IFRS 3 coherently and constructively. The onus is on management to provide robust IFRS numbers, and to explain them convincingly. From now on, effective due diligence means carefully assessing the intangible assets within potential targets, as well as properly taking into

account the financial impact of any proposed acquisition. It is clear that the introduction of IFRS 3 will have very significant business implications for both CFOs and CEOs. From now on, they need to understand and be able to communicate how acquisitions will be accounted for, as well as explain precisely what has been acquired. As a general observation, senior management is likely to find itself coming under much greater scrutiny from the investment community on all future deals.

The overriding advice is that management needs to understand the issues involved and plan ahead in order to take advantage of opportunities, create headroom and avoid unpleasant surprises.

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Tony Hadjiloucas is a valuation specialist and has around 10 years' experience with PricewaterhouseCoopers, primarily in M&A and corporate finance-related areas. He is currently a key member of PricewaterhouseCoopers' Valuation & Strategy practice in London, where he leads the delivery of valuations of brands, patents, know-how and other intangible assets, and regularly advises on transactions involving such assets in the UK and throughout the world.

Mr Hadjiloucas recently provided a valuation opinion and testified as an expert witness in a case involving a leading global consumer goods brand. He has also assisted many blue-chip clients in developing strategies in connection with exploiting

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