

## Valuations: goodwill hunting

Chris Thorne | AccountancyAge | 03 June 2010 | 00:15

The murky world of valuing intangible assets has just become a little clearer



To those of a scientific leaning who value the empirical above all else, something that is intangible is to be treated with suspicion. The tangible is real and provable; the intangible illusionary and speculative. However, intangibility is all around us.

The American philosopher Henry David Thoreau once noted: “The true harvest of my life is intangible – a little star dust caught, a portion of the rainbow I have clutched.”

To put it more prosaically, tangible things would be pretty dull if it were not for lustre brought by the intangible.

In the world of business the importance of the intangible asset is clear for all to see. How much of the £11.5bn Kraft agreed to pay for Cadbury was attributable to its buildings, plant, cash or investments and how much to Cadbury’s globally known brands and established customer relationships?

When Tata Motors bought Jaguar Land Rover from Ford, it certainly was not motivated to pay over £1bn for either an established flow of profits or the prospect of owning under-invested car plants in the West Midlands and Merseyside and a £600m pension deficit. Intangible certainly does not equate to unreal.

The importance of recognising the value of intangible assets such as trademarks, brand names, intellectual property, customer relationships or an assembled workforce has been recognised by accounting standard setters. IFRS 3 – Business Combinations, which became effective in 2004, requires the acquirer to establish the total fair value of all tangible and intangible assets or liabilities in the acquired business, with any positive difference between the price paid and the total being treated as goodwill.

Although in some parts of the world, principally North America, there has been an established body of academic study into methods that could be used to value intangible assets, until comparatively recently the practical application of this theory was limited.

Prior to IFRS 3, there was no need for businesses to analyse too deeply either the price they paid for intangibles or how that price should be allocated in the accounts, providing the overall price paid for a business made sense based on price-earnings ratio, net asset value or some other all encompassing benchmark. However, times are changing and the focus of analysts and investors is being increasingly drawn towards the intangible assets on the balance sheet.

In January 2010, the Financial Reporting Council (FRC) reported the results of a study undertaken of the accounting for 20 acquisitions that had taken place in 2008. It assessed the quality of the information provided in the business review and the disclosures about intangible assets and goodwill in the audited accounts. Although the study found that nearly all the companies included in the study gave logical and

seemingly comprehensive reasons for acquisitions in the business review, in only 20% of the cases did the FRC find a coherent and consistent link between this information and intangible assets recorded in the balance sheet.

In over a third of cases there were failures to comply with the requirement in IFRS 3 to identify separately different classes of intangible asset in each material transaction. This restricted the ability of a reader of the accounts to understand the amount of the acquisition price allocated to intangible assets in individually material acquisitions. It appears that many acquiring companies – and by extension their auditors – satisfied themselves that there was no need to identify separate intangibles because they could not be measured reliably, in spite of the fact that, wittingly or unwittingly, they had paid good money for those assets a short time earlier. However, this means of avoiding the transparency intended by the standard has been removed by the July 2009 amendment to IFRS 3 that provides that if an intangible asset can be separately identified then it can be measured reliably, as the two conditions are interdependent. This will place further pressure on companies to properly consider the nature and value of any intangible assets they acquire.

The International Valuation Standards Council (IVSC) became aware that, although the introduction of IFRS 3 increased the demand for the identification and valuation of intangibles, there was little in the way of globally accepted standards of best practice. Although the International Valuation Standards contained a short guidance note on intangibles (GN4) that had been developed in the late 1990s, this predated IFRS 3. There was clearly a need for more extensive guidance in this area to help bring about consistency of application. In 2006 it commissioned a major project to review and develop standards and guidance on the valuation of intangibles. Following the publication of a discussion paper, an exposure draft, round table meetings and consultation with International Accounting Standards Board staff, a revised GN4 was published in February 2010. Although not exclusively aimed at valuations under IFRS, it is intended that the new guidance will give both preparers of financial statements and auditors a better understanding of the characteristics of different classes of intangible assets and acceptable approaches to their valuation.

The publication of GN4 is not the end of IVSC's intangibles project. This is a young and rapidly developing sector of the valuation profession and there is also clearly a need for the development of specific guidance to assist valuation practitioners. The IVSC is collaborating with the Appraisal Foundation, a federally mandated standard setter in the US, in the development of guidance on contributory assets and customer relationships, and further topics are under discussion.

Hopefully, the revised GN4 will be a significant step towards improving understanding and application of the reporting of intangible assets, and shine a light into what has for too long been a murky corner of too many balance sheets.

*Chris Thorne is chairman of the International Valuation Standards Board.*