BRAND·FINANCE® Brand Finance Report

Implications of the new international accounting standards for intellectual property owners

The Standards Have Landed

On 31 March 2004 the International Accounting Standards Board (IASB) issued IFRS 3 "Business Combinations" (replacing IAS 22 "Business Combinations"). Accompanying revisions were also made to IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets". Although differences remain, the new standards in this area achieve a high degree of convergence with US GAAP. FAS 141 "Business Combinations" and FAS 142 "Goodwill and Other Intangible Assets" in the US have already had important implications for brand owners and the way trademarks are valued and accounted for. For the first time, trademarks and other acquired intangibles had to be separately recognised on the balance sheet.

IFRS 3 also requires identifiable assets to be recognised on the balance sheet of the acquiring entity, provided that certain conditions are met. This is a significant change from most existing (non-US) national accounting standards. These and other significant new disclosures in respect of the cost of acquisition and the main classes of assets and liabilities will mean greater transparency and will require a much more detailed due diligence process.

Following recognition, the requirements of the new standards are more onerous than before. Goodwill and intangible assets with indefinite useful economic lives will need to be tested at least annually for impairment.

It seems likely that many companies will require independent specialist valuation assistance in order to withstand the market scrutiny that greater transparency will bring and to satisfy the need for objectivity and auditor independence.

In the countries where the new IAS are being adopted, IFRS 3 is effective immediately and should be applied by quoted companies prospectively to business combinations entered into on or after 31 March 2004. The new requirements to be applied in accounting for existing goodwill and negative goodwill are effective from the beginning of the first reporting period beginning on or after 31 March 2004.

The policy with regard to unquoted companies varies by country. In the UK for example, adoption of IAS is voluntary, whereas in several European countries such as France and Spain, unlisted companies will not be allowed to adopt IAS. Where allowed, voluntary adoption of IAS by unquoted subsidiaries of a quoted company would certainly simplify consolidation and also prevent having to implement piecemeal changes as national standards boards make changes to their own standards to come into line with IAS (as is the intention in the UK for example).

IFRS 3 Overview

Method
The purchase method of accounting (or acquisition accounting) must be used.

Assets and liabilities acquired
Recognition of more intangible assets and contingent liabilities at fair value at acquisition date.

Goodwill
Not amortised but tested for impairment at least annually.

Negative goodwill
Recognised as profit or loss immediately.

Impairment testing
Detailed disclosures about transactions and impairment testing are required.

Historic transactions
Adopters of IFRS 3 can choose to restate past deals.

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Allocating the cost of a business combination

At the date of acquisition, the acquirer must allocate the cost of the business combination by recognising the acquiree's indentifiable assets, liabilities and contingent liabilities (including any proportion attributable to minority interests) at their fair value. Any difference between the total of net assets acquired and cost of acquisition is treated as goodwill or negative goodwill.

Intangible assets

All identifiable intangible assets of the acquired business must be recorded at their fair values.

To be recognised separately the asset must meet the following criteria:

- Separately identifiable (an asset is identifiable when it either arises from contractual or other legal rights or is separable. An asset is separable if it could be sold, on its own or with other assets)
- Controlled by the entity
- A source of future economic benefits
- The fair value can be measured reliably

IFRS 3 includes a list of assets that are expected to be separately recognised from goodwill. In many instances the valuation of such assets is a complex undertaking and companies may prefer to outsource this activity to independent specialists.

Examples of intangible assets to be separately recognised

Marketing relate
Trade marks, brands, trade names, trade dress, internet domain names

Contract based
Licensing and royalty agreements, contracts for advertising, construction, management, service or supply, lease agreements, franchise agreements

Technology based
Patented technology, computer software, databases, trade secrets

Customer related
Customer lists, order or production backlog, customer contracts and related relationships

Artistic related
Plays, operas, ballets, books, magazines, newspapers, musical works, films

Goodwill

After initial recognition of goodwill, IFRS 3 requires that goodwill be recorded at cost less accumulated impairment charges. Whereas previously under IAS 22 goodwill was amortised over its useful economic life (presumed not to exceed 20 years), it is now subject to impairment testing at least once a year. Amortisation is not permitted. A revised IAS 36 will be applied to test for impairment. This is a significant change and fulfilling the new requirements will clearly be more onerous than in the past.

Impairment of assets

A revised IAS 36 "Impairment of Assets" was issued at the same time as IFRS 3. Previously an impairment test was only required if a triggering event indicated that impairment might have occurred. Under the new rules, an annual impairment test is required for certain assets, namely:

- Goodwill – tested annually and at any other time when an indicator of impairment exists
- Intangible assets with an indefinite useful economic life and intangible assets not yet available for use – the recoverable amount of these assets must be measured annually (regardless of the existence or otherwise of an indicator of impairment) and at any other time when an indicator of impairment exists

Brands are one type of intangible asset, which are frequently claimed to have indefinite useful economic lives. Where acquired brands are recognised on the balance sheet post-acquisition it will be important to establish a robust and supportable valuation model using best practice valuation techniques which can be consistently applied at each annual (or perhaps more frequent) impairment review.

The revised IAS 36 also introduces new disclosure requirements. The principle requirement being the disclosure of the key assumptions used to measure the recoverable amounts of intangible assets. An analysis of the sensitivity of the impairment review conclusion to those assumptions may also be given. Increased disclosure is required where a reasonably possible change in a key assumption would result in actual impairment.

The requirement for separate balance sheet recognition of intangible assets, together with impairment testing of those assets and also goodwill, is expected to result in a significant increase in the involvement of independent specialist valuers to assist with actual valuation and also on appropriate disclosure.

other intangible asset valuation

Brand Finance has previously advised on a number of significant brand valuations for FAS 141 (the US equivalent of IFRS 3) purposes. Examples include the valuation of brands for SAB Miller (following its acquisition of The Miller Brewing Company in 2003) and for Groupe Danone (following the acquisition of the Frucor Business in New Zealand in 2002).
It has also carried out goodwill impairment reviews following initial recognition.

Implications for intellectual property managers

Greater transparency, rigorous impairment testing and additional disclosure will result in more scrutiny by the market and will have a significant impact on the way companies plan their acquisitions.

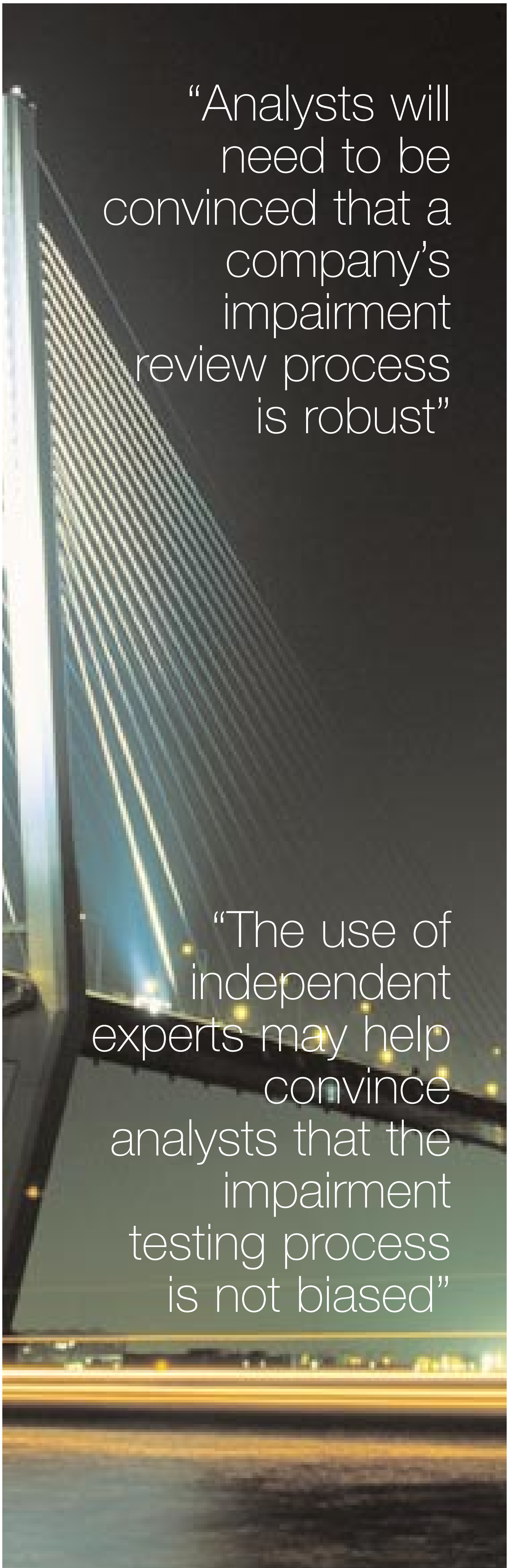
Intellectual property managers must ensure that they have the necessary skills to satisfy the new requirements and to withstand market scrutiny.

More regular impairment testing is likely to result in a greater volatility in financial results. Analysts will need to be convinced that a company's impairment review process is robust. In the case of brand and other intangible asset valuation, where a high degree of subjectivity can exist, it will be important to demonstrate that best practice techniques are being applied. The use of independent experts may help convince analysts that the impairment testing process is not biased.

In terms of planning prior to acquisition, a detailed analysis of all potential assets and liabilities is recommended to assess the impact on the consolidated group balance sheet and P&L post-acquisition.

A more detailed due diligence is recommended. In the case of brands, a "Brand Due Diligence" should be considered. This is a robust appraisal of the brand expressed in business valuation terms, covering all the legal, financial and commercial angles. A Brand Due Diligence reports includes a "Branded Business" valuation, segmented by key market, a brand valuation, an understanding of what drives demand and loyalty and a detailed appraisal of various alternative growth and value scenarios.

In a situation where the value of the brand will need to be appraised for the purposes of post-purchase allocation and recognition on the balance sheet, it would seem to make sense to extend this process into a full Brand Due Diligence review. This could also provide valuable information and insight to the acquirer during the negotiation process and identify any potential risk of future impairment of the brand.



What is included in a Brand Due Diligence?

There are five key steps:

1. Legal review and risk analysis
Involves understanding the nature of the franchise:
- Are trademarks registered in all territories and business classes?
- Are trademarks properly protected?
- Are trademark rights sold, shared or licensed?
- Are sales being lost through parallel trading or counterfeiting?

2. Market review and risk analysis
Involves understanding the risk profile of the industry:
- Is the industry in a growth or decline phase?
- Is the industry stable or particularly vulnerable to social, economic, political, technological or environmental factors?
- How are developments in e-commerce and the internet affecting the distribution channels in the industry?

3. Competitor review and risk analysis
Involves understanding the competitor landscape:
- Who is the market leader and what is its strategy - is it integrating up/ down/ across?
- Which of the other players are considered market challengers/ followers/ nichers and what appears to be their marketing strategy?
- What are the barriers to entry in the market?

4. Brand image review and risk analysis
Is the brand well managed?
- Customer target profile
- Pricing strategy
- Adequate marketing support
- Responding to changing environment

Is there protection against reputation damage?
- Product malfunction
- Personnel error
- Ethical or environmental problems

5. Branded business review and risk analysis
- Is there any sustainable competitive advantage?
- Product innovation
- Manufacturing capability
- Distribution/ channel structure
- Quality of service/ people
- Lowest cost/ price
- Customer loyalty/ inertia
- Intangible differentiation

Conclusion

The introduction of IFRS 3 for acquisitions after 31 March 2004 is expected to have important implications for brand owners and the way trademarks are valued and accounted for. In particular, the separate recognition of trademarks and other acquired intangible assets, together with subsequent annual testing for impairment, will require companies to establish robust intangible asset valuation methodologies, which will stand up to increased scrutiny by the market.

A more rigorous and detailed due diligence process should also be developed. In cases where the acquired brand is considered to represent a significant proportion of total intangible asset value, a "Brand Due Diligence" should be considered.

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Michael Rocha, Managing Director

Brand Finance plc

Brand and other intangible asset valuation techniques

There are several alternative valuation approaches available. For these purposes we will refer to brand valuation for the remainder of this section. However, the techniques described may equally be applied to the valuation of many other forms of intangible asset.

Cost based

'Creation costs' may be estimated by looking back to brand launch and restating actual expenditure in current cost terms. This approach may provide a meaningful number for a new brand, where the time period is short and the costs are readily available. However, even when costs can be collected consistently the answer does not represent the current value of the brand.

'Re-creation costs' may be also estimated. The obvious difficulty is that there is no such thing as an identical brand so it may be hard to calculate a relevant re-creation number. Brands are valuable because they are unique. By their very nature they are not comparable or replicable.

For these reasons cost based valuations are usually only commissioned as a sense check.

Market based

This assumes that there are comparable market transactions (specific brand sales), comparable company transactions (the sale of specific branded companies) or stock market quotations (providing valuation ratios against which a comparable branded entity can be valued). A valuation may be based on the disposal of comparable individual brands, specific branded divisions or whole companies where adequate information is made publicly available.

In practice, there are few directly comparable transactions. Even where there are sales of specific brands or branded businesses, details are generally not widely available, and it is hard to make comparisons.

In addition, the notion of comparability assumes that brands are identical, which is never the case. Market based valuations also tend to be used only as a sense check.

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Income based

Two alternative approaches are popular:

Royalty Relief

This assumes that a company has no brand and needs to license one. If a brand has to be licensed from a third party a royalty rate on turnover will be charged. By owning the brand such royalties are avoided. Ownership therefore relieves the company from paying a license fee (the royalty rate) – hence the term royalty relief. The royalty relief method involves estimating likely future sales, and then applying an appropriate royalty rate to arrive at the income attributable to brand royalties in future years.

Using a Discounted Cash Flow (DCF) technique the valuer discounts estimated future royalties, at an appropriate discount rate, to arrive at a Net Present Value (NPV) – the brand value.

The advantage of this approach is that there are many examples of royalties in use by companies licensing brands to one another.

Economic Use

This considers the economic value of a brand in current use to current owner. In other words, it considers the return that the owner actually achieves by owning the brand – now and in the future.

Economic use valuations assume that brands provide their owners with security of demand. In the short run a manufacturer without a brand might enjoy the same sales, the same economies of scale, even the same premium prices as the manufacturer with a brand. However, the non-branded manufacturer could not rely on the same security of knowing that the brand's customers this year are likely to be customers of the brand next year, and for many years after that.

This approach also depends on the accuracy of future sales and earnings projections. It uses the future earnings attributable to a brand after making a fair charge for the tangible assets employed. A charge is also made for tax at a notional rate. The resulting brand earnings are discounted back to an NPV representing the current value of the brand.

Typically such brand valuations are based on 3-5 year earnings forecasts. In addition, an annuity is calculated on the final year's earnings on the assumption that the brand continues beyond the forecast period, effectively into perpetuity. As brand rights can be owned in perpetuity and many brands have been around for over 50 years, this is not an unreasonable assumption.

Steps in an Economic Use valuation

1 Modeling the market (to identify market demand and the position of individual brands in the context of all other market competitors. Usually the valuation model is segmented to reflect the relevant competitive framework within which the brand operates).

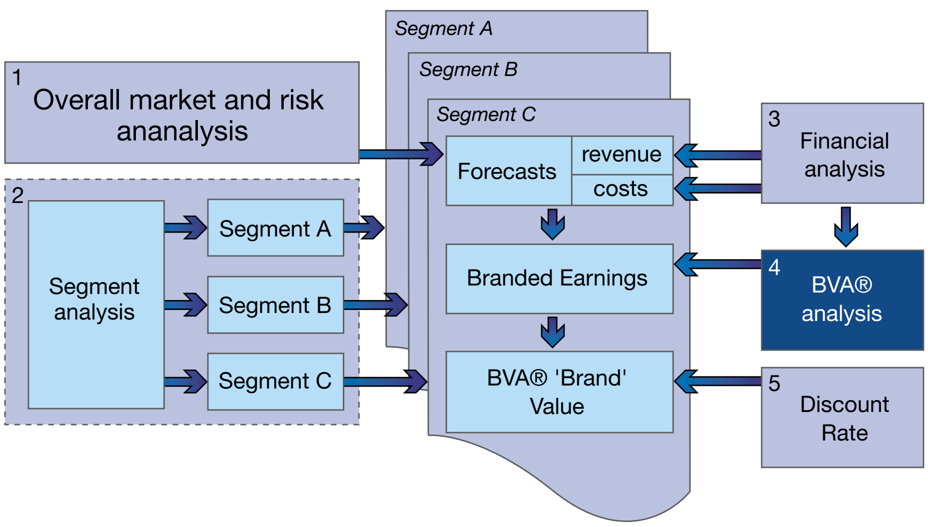
2 Forecasting economic value added of the branded business (to identify total branded business earnings).

3 Estimating Brand Value Added BVA® using business drivers research (to determine what proportion of total branded business earnings may be attributed specifically to the brand).

Benchmarking brand risk rates - Brandßeta® analysis (to assess the security of the brand franchise with both trade customers and end-consumers and therefore the security of future brand earnings). The resulting discount rate is used in the DCF calculation.

The schematic below illustrates how these work-streams fit together:

Economic Value Added valuation model



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