

South Africa

Impairment testing of acquired intellectual property in developing economies

When they were first implemented, International Financial Reporting Standard (IFRS) 3 and International Accounting Standard (IAS) 38, requiring acquired goodwill and intangible assets with indefinite useful lives to be tested annually for impairment, caused some surprise in the investment community.

One of the more startling examples of early experience of the requirement was the magnitude of the impairment charge recognised in the balance sheet and income statements of Vodafone in respect of its acquisition of Mannesmann's cellular telephony licences and business. This impairment charge, running to several billion pounds sterling, arose from the early failure of the acquired business to yield the anticipated revenues and profits upon which the original purchase price had been premised. This is the most common circumstance triggering mandatory recognition of the impairment of acquired goodwill and intangibles with an indefinite useful life.

In the case of acquired goodwill and intangibles with an indefinite useful life, recognition of an initial impairment is permanent. While the applicable reporting standards permit the subsequent recognition of reversals of an impairment charge in the case of intangibles with a finite useful life, subsequent factual reversals of impairment are not recognised in the case of acquired goodwill and intangibles with an indefinite useful life.

Impact on acquired intellectual property

The applicable reporting standards provide a challenge in the case of acquired intellectual property. Acquired patents, designs, copyrights, proprietary know-how, trade secrets, trademarks, brands, mastheads and publication titles and similar material invariably fall into the category of intangibles with an indefinite useful life, as that concept is understood under the reporting standards.

The challenge manifests itself as follows. By its nature, intellectual property is directed at protecting new products, processes and methods and the means

of procuring and marketing them. Often the price paid for the properties at issue is at an early stage of their useful lives and is premised on the expectation and hope that they will give rise to new categories of business, and even the creation of hitherto unknown business sectors. The price of acquiring intellectual property (or the cash-generating units where use is to be made of the intellectual property) is frequently premised on revenue and profitability forecasts that rely on supposition, or at best on analogies drawn from experience gained or gleaned from ostensibly comparable new product introductions – with varying degrees of reliability and appositeness.

Naturally, the price paid will depend on both the extent of the anticipated uptake of the new product in the marketplace and, more significantly, the timeframe in which such uptake is to take place.

The timeframe issue

In the case of a business acquired for the promise of its new technology, which is to be implemented in industries characterised by long timescales, the challenge is less daunting. The mining industry is a case in point. A deep-level mining project often takes years to implement and investment is made on the basis of a lengthy timescale. Thus, an intrinsically rich and substantial ore body will, because of historically experienced ore extraction problems under previously available extraction technology, credibly be viewed as viable in the light of a new but partially proven ore separation and extraction process. Due to their nature, the viability of such processes can be assessed only on a pilot plant basis. However, their ultimate success depends on overcoming significant scale-up issues in the context of the ore extraction volumes required if the actual ore body in respect of which it is to be used is to be viable. By way of example, at the beginning of the 1980s the South African platinum mining industry supplied around 33 per cent of the world's platinum. Significant platinum-bearing UG-2 ore bodies had been

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proven, but their viability depended on the introduction of new extraction processes – whose successful uptake over the next 20 years enabled that industry to command in excess of 75 per cent of the world’s platinum production.

In circumstances such as this, testing the impairment of the purchase price paid for the acquisition of a mining operation that had commenced development of a promising ore extraction or ore treatment process that offered the prospect of revolutionising the industry on too rigid and inflexible an impairment timeframe would be unrealistic.

Banking the unbanked

An example from the cellular telephony industry as it manifests itself in developing markets is similarly instructive. Much of Southern Africa, as well as other areas of the continent, is significantly under-banked. In contrast, cellular telephony coverage has spread significantly – for example, in South Africa, the number of issued SIM cards equals 110 per cent of the total population. Cellular telephony offers the prospect of sophisticated new-age banking services being introduced to a significant cellular telephony-savvy population, leapfrogging the need to introduce conventional banking to a largely unbanked population.

In classical terms, a banking group might overpay for an interest in a cellular telephony provider business because expected revenues and profits from the acquired network do not meet expectations. However, if the express strategy of the acquisition is not so much the acquisition of the cellular telephony business *per se*, but its evolution into a new form of banking business, considerable care needs to be taken in assessing whether an impairment should be recognised during the early

years of such an acquisition if the impairment charge is to be realistic.

The existing IFRS and IAS guidelines for impairment testing provide inadequate guidance for dealing with impairment of the acquisition cost of technology-rich businesses in developing countries whose economies are characterised by ongoing technological shifts of significant proportion.

Principal flaw

The rationale advanced by the applicable reporting standards for distinguishing goodwill and indefinite useful life assets from other assets is twofold:

- Goodwill and indefinite useful life assets must be used in conjunction with other assets in order to yield revenues; and
- There is no readily ascertainable marketplace wherein the value of goodwill and indefinite useful life assets can be reliably established.

The distinction is more apparent than real. Real estate (the ostensible high-water mark of a finite asset) is a case in point. In apparent terms, a piece of real estate generally has a readily ascertainable market price. However, in real terms, the intangibles of the property company that identified and acquires the real estate generally establishes its value – that is, its skill in the timing of the acquisition and in identifying both the nature and cost of the refurbishment required to extract optional rental value. In short, a building in the hands of a property magnate is a very different proposition from one in the hands of a less skilful title holder.

Few, if any, so-called finite assets can withstand this kind of scrutiny. The result is that the distinction made by applicable reporting standards between goodwill and

indefinite useful life assets, and so-called finite assets with a readily ascertainable market value, is of questionable utility as an accounting standard.

The most pernicious downside of an impairment regime which does not recognise impairment reversals in the case of acquired goodwill and indefinite life intangibles is that it encourages endemic risk to be hidden and forgotten, because it allows dubious assets to be written down rapidly, and effectively to be expunged as meaningful information from the financial statements. It does so by preventing the effective exposure of the potential for ongoing harm to the acquirer's business from assets which fail to meet the revenue and margin expectations for which they were ostensibly acquired, while at the same time, where an actual reversal is taking place, masking identification of the asset that is responsible for the reversal.

Sunset industries in developed and developing economies

The principal flaw indicated above is nowhere demonstrated more acutely than in the failure of attempts to create growth (from finite assets), namely in the treatment by governments of sunset industries

in developed countries. A good example is the motor industry which, in order to prosper, must implement efficiencies and business development strategies largely unachievable in developed economies. The recent US federal bail-outs of the domestic motor industry stopped in August 2009 – and the industry is now back in a crisis which looks likely to be terminal.

As the *New York Times* observes, a similar phenomenon can be seen in Japan, which has stagnated as huge public works programmes aimed at reviving the economy saw core capital flow to moribund industries instead of fostering new ones, failing to lift the country out of the doldrums while creating a huge debt burden.

Of course, this problem is also apparent in South Africa and impacts on growth there in a similar manner to that seen in other countries around the world.

An impairment regime which permitted the recognition of reversals of acquired goodwill and other indefinite life intangibles would enable financial statements more clearly to reveal whether intangibles acquired to support and engender growth do in fact achieve this. It would also make management more accountable to investors and stakeholders.



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