

Chorion and Intangible Fixed Assets and Impairment Charges

By Jim Shoemsmith, Editor of *The Serious Investor*.....10th June 2005

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At the last WBW (Warren Buffet Way) SIGnet Group meeting (Tuesday 7th June 2005) we considered Chorion, one of IFG's current major recommendations. One member, Peter Webb, raised an important issue regarding their accounting policies for the write off of Intangible Fixed Assets. At the request of the Group I sent an email to Nigel Milton the editor of IFG asking for his views; the substance of the email was as follows

Almost all the Intangible Fixed Assets are copyrights (£57,851m out of a total of £58,914m, 97%). A note in the 2004 accounts (page 36, note 9) describes these as mainly relating to Agatha Christie, Georges Simenon and Mister Men; these are being written off in equal instalments over the remaining copyright period, which is due to expire in 2046, 2059 and 2058 respectively. The copyright write off in 2004 was only £955,000, about 1.6% of book value, though Mister Men did not have a full years charge as acquired during the year. Writing an asset over a period of 40 – 50 years or more seemed to us an excessively long period; who knows whether these still be popular then.

We were also intrigued by the particular dates. The Berne Convention establishes a general and minimum period for copyright to last the life of the author and fifty years after his (or her) death. But Agatha Christie died in 1976, so how can the copyright expire in 2046, 70 years after her death?

For comparison purposes, we looked at the accounting policies of Hit Entertainment and their write down of 'acquired rights' (the nearest comparative asset) is on a straight-line basis (the same as Chorion) but over 'the economic lives not to exceed 10 years' (the key differences being 'economic lives' not 'copyright period' and 'not to exceed 10 years'. Their policy is therefore very, very much more prudent.

If Chorion were to adopt the 10 year maximum then the write off in 2005 would be almost £6m and wipe out any profit.

While we would not suggest that this policy is 'imprudent' (the auditor KPMG have signed up to it); it does however seem to us to merit some further investigation. Particularly as it is a policy that is so fundamentally substantial in relation to their profit that it is not an academic accounting matter, but one that should fundamentally affect an investors' view of the whole company.

Nigel forwarded this to Sue Murphy the Finance Director of Chorion who replied, almost by return of email, as follows.

There are two points to address; (1) the length of copyright period; and (2) the useful economic life of Chorion's assets.

1. Length of copyright period.

The duration of copyright in respect of works originating in the UK, for a literary, dramatic, musical or artistic work lasts for the life of the author and 70 years from the end of the year in which he/she died.

Jim has correctly quoted the Berne Convention, which provided for a minimum term of copyright protection of the life of the author plus fifty years, but parties were free to provide longer terms of copyright protection. This longer copyright period of 70 years was adopted by the European Union with the 1993 Directive on harmonising the term of copyright protection and was followed by the United States with the Sonny Bono Copyright Term Extension Act of 1998. As a result, the period of 70 years from death of the author is universally applied, not 50 years as suggested by Jim.

2. Useful economic life of Chorion's assets.

The directors are responsible for assessing the useful economic life of each class of assets. In respect of copyrights, Chorion owns assets that generate economic value over the period to the

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expiry date of the copyright. The directors therefore consider that the remaining copyright period is an appropriate period over which to amortise the value of the copyright currently held on the balance sheet.

In addition, we carry out an impairment test each year, which is audited, to ensure that the value of the unamortised copyright is supportable by future revenues. This enables us to ensure we remain comfortable with this assumption.

Jim is correct in saying that this policy is fundamentally substantial in respect of Chorion's profit. As such, it would not be correct to amortise this investment over a short period of say, 10 years, as suggested, as there is clear value being generated by the assets over a much longer period. Although this amortisation period exceeds 20 years, this policy is entirely appropriate in these circumstances.

The comparison drawn with HIT's accounting policies is, in fact also not correct. HIT's amortisation policy is not in respect of copyright, but is in relation to programming assets. Chorion's own policy on amortising TV and film assets is entirely in line with HIT's, which, for new assets created since 2002 has been set at ten years.

Finally, I would make the point that the presumption of a 20-year maximum life for goodwill and other intangibles under current UK GAAP disappears under International Financial Reporting Standards, with the value of the asset being tested annually for impairment. Intangibles with indefinite useful lives will not be amortised, but subject to annual impairment, while intangibles with definite useful lives (such as copyrights) would be amortised over that life, while also being subject to annual impairment tests.

I hope this provides a useful summary of this issue.

I circulated this to everybody in the WBW Group with the following comments.

As an accountant, I agree with Sue and would almost certainly do the same thing in her position; companies generally do adopt the most beneficial accounting policies.....one clear argument being that if they don't then their comparator companies may, and then the investment community will view them in a bad comparative light. But as an investor such a long write off period does still concern me.

But the answer is that now and more particularly under IFRS the annual impairment reviews are the key test and impairment charges to P&L will need to be made if future revenues don't justify the balance sheet value. But there is no transparency on these tests and the underlying assumptions. (WPP's finance director, huge goodwill on that balance sheet, has told me that there is some consistency in terms of assumptions and mathematics behind these tests, and they are audited so not entirely at management's 'whim'.) But there is still more 'room for maneuver' than with straight line write offs. In the past, accountants used to say that they would prefer to be precisely wrong (straight line write offs) rather than approximately right (impairment tests), so perhaps we are moving towards being approximately right. One-off impairment write-offs will however, I suspect, be highlighted as 'exceptional' or something and not taken fully into account when assessing annual profits; perhaps taken when new management take a 'bath' and cleans up the balance sheet.

Perhaps the underlying lesson is that all accounts need to be studied and interpreted, not just taken at face value.

And if the 'City' bases their valuation of Chorion and its share price - consistently - on their accounts (and other matters) then it should not matter.

I hope that this was useful not just as regards Chorion but also the wider points on intangible assets, IFRS and impairment charges.
