GIVING SUBSTANCE TO INTANGIBLES

INSTITUTE'S VIEW OF ACCOUNTING STANDARD

Inadequate requirements for the reporting of intangible assets have left many shareholders and investors with an incomplete picture of company values. A Securities Institute report points to some remedies.

The Accounting for Intangibles Subcommittee of The Securities Institute of Australia was formed to ascertain the views views of institute members about the proposed issue by the accounting bodies of a new standard on accounting for identifiable intangibles such as brand names.

This paper, an edited version of the subcommittee's report, examines the advantages and problems of the existing standard, defines identifiable and unidentifiable intangibles, assesses the valuation methodology and makes recommendations about the accounting treatment of brand names and other identifiable intangibles.

The existing goodwill standard capitalises purchased goodwill and amortises it. In essence, it recognises the cost of acquisition, records custodianship of shareholders' funds, recognises (albeit approximately) that goodwill is a wasting asset, and overcomes (again, approximately) the significant problem of annually valuing goodwill.

The standard is consistent with the accounting concept of conservatism, it does not distort cashflow, and it reduces (but does not eliminate) the scope for creative accounting of the less-desirable kind.

However, the existing standard carries with it a number of problems.

It covers only goodwill arising on acquisitions and prohibits the valuation of internally generated goodwill. For this reason, the existing standard deals only with "half the issue".

It is not clear about the distinction between identifiable intangibles (for example, brand names, licences etc) and unidentifiable intangibles.

It assumes that goodwill is a wasting asset in all cases. This is clearly open to question. The standard does not recognise that goodwill may be maintained, increased or dissipated through good or bad management, ongoing expenditure or market forces. Further, it ignores the fact that some intangible assets have a life in excess of any arbitrary write-off period. The brand name Coca-Cola is an example.

Other problems with the existing standard are:

- It distorts the rate-of-return analysis by affecting both the numerator and denominator.
- It encourages avoidance techniques such as revaluing licences or making selective revaluations.
- It ignores the corresponding goodwill of the purchaser issuing shares with a goodwill element in their price.
- It encourages inconsistent treatment between companies and over time.
- It distorts the matching of costs and revenue (eg, "maintenance expenditure" on advertising).
- It fails to acknowledge that accounting concepts do not recognise some fundamental valuation issues (such as NPV) and this failure is partly reflected in goodwill.

In the valuation of intangibles, it is necessary to divide the assets into identifiable and unidentifiable intangibles.

Identifiable intangibles (see box) may be defined as those intangible assets which are legally separable from the entity, which are capable of producing economic benefits in their own right, and the economic benefits of which are capable of being transferred to a third party.

So far as is practicable, separate values should be allocated to the identifiable intangibles. These values should be set on the basis that each asset (or the benefit it generates) is separate, on a stand-alone basis, from the rest of the business.

Subject to the comments on annual revaluations set out in this paper, these values should be written off over the legal or expected life of the asset – or no more than 20 years where the life is indeterminate. The 20-year period has been chosen only to be consistent with the existing standard on goodwill.

Unidentifiable assets are generally described as goodwill. This would include any over-payment due to general market conditions or purchaser's error (which should be written off immediately).

The balance of unidentifiable intangible assets should be written off over a period not exceeding 20 years in accordance with the accounting standard on goodwill.

Write-off periods

Because most trade names and other intangibles are wasting assets, some write-off period needs to be set.

Any write-off period is necessarily arbitrary. Around the world, various accounting standards require the write-off of goodwill over periods ranging from one year to 40 years (in some cases, these periods are influenced by tax considerations).

In Australia, the write-off period in the accounting standard on goodwill is a maximum of 20 years.

Corporations which wish to avoid an annual write-off may do so by having their identifiable intangible assets revalued annually. (For any directors' valuation to be credible, it should be supported by regular, independent valuations.) Provided there is no diminution in value during the year, no charge is required against operating profits. This is broadly conceptually consistent with the treatment of depreciation on buildings.

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In the absence of an annual revaluation, identifiable intangibles should be amortised over their expected or legal life or 20 years, whichever is the shorter.

Valuation methodology

A common method of calculating acquired goodwill is to deduct from the cost of the purchase (after appropriate allowance for any averaging) the fair value of net tangible assets and liabilities.

Intangible assets should be divided into identifiable and unidentifiable intangibles as set out earlier. The correct method of valuing intangibles, whether on acquisition or revaluation, is to value them from first principles.

Values determined on first principles should be assessed against criteria such as:

- net present value of future cash streams (NPV);
- replacement cost (net of tax);
- historic cost (net of tax);
- net realisable value (NRV) – that is, what someone else would pay; and
- relief from royalty method.

Clearly, the upper limit in any value is set by the NPV or NRV of the asset. Given the limitations of historic cost, it appears that replacement cost (net of tax) should set the absolute maximum value if other bases are inapplicable.

Valuations should, at the very least:

- divide intangibles into their component parts;
- where practical, attribute a separate value to each component, such value being subject to the tests that the asset is "stand-alone" or legally separable, and that its economic benefits are capable of being transferred to a third party;
- be regularly reviewed and not be carried at a value that exceeds the lower of either replacement cost (net of tax) or net realisable value;
- take into consideration the fundamental accounting principal of conservatism;
- be revalued only when all assets in the intangible class are revalued;
- make due allowance for such factors as fashion, synergy and personality cult;
- be made on the basis of fair market value as determined by a knowledgeable, willing buyer and a knowledgeable,

WHAT ARE THE 'IDENTIFIABLE' INTANGIBLES?

Identifiable intangible assets which would be affected by the new accounting standard include the following:

- brand names
- scarce resources
- licences
- contracts
- trademarks
- patents
- formulations
- concessions
- technical know-how
- copyrights
- quotas
- franchise rights
- customer lists
- computer programs
- management contracts
- net present value adjustments not reflected in the accounts
- transaction costs.

willing seller acting in an arm's-length transaction.

Recommendations for a standard

The new standard for the accounting treatment of brand names and other identifiable intangibles should be consistent with existing accounting standards and with the fundamental accounting concepts of prudence, consistency, going-concern and the matching principle. There is an overriding requirement that accounts should not be misleading.

Broadly similar principles to those used in the accounting treatment of land and buildings, building depreciation and building maintenance should apply. The wasting component should be written off to the profit-and-loss account, the non-wasting component should not.

Land is not depreciated because, generally, land does not deteriorate. In contrast, goodwill, brand names etc. generally do deteriorate over time.

Those identifiable intangibles of indefinite or indeterminate life could be revalued annually. This would have the effect, where there is no diminution in value, of avoiding an annual charge against profits.

The values put on many companies by the stockmarket often indicate that the market perceives a value in a business and its underlying assets, particularly intangibles, which is greater than that shown in the company's balance sheet. This suggests that shareholders, potential investors, employees, lenders and creditors are not fully informed about the value of the assets of the company.

A solution is to require that *all* identifiable intangibles, whether purchased or internally generated, should be recorded on the balance sheet.

The value shown would be the directors' best estimate but could not exceed the value set by an independent valuer where such valuations have been obtained. The directors' valuation would be subject to review by the auditors.

Purchased goodwill would continue to be recorded in accordance with ASRB 1013.

In recent times, the aim of the unscrupulous has been to inflate reported profits or asset values. This could be avoided by the following provisions:

- Purchased intangibles should be shown on the balance sheet initially at cost.
- Internally generated identifiable intangibles, excluding goodwill, should be stated at valuation with the credit to the asset revaluation reserve.
- The revaluation of identifiable intangibles should be debited or credited, as the case may be, to the asset revaluation reserve in the same way as other non-current assets (refer ASRB 1010).
- Annual amortisation of identifiable intangibles and goodwill should be charged to the profit-and-loss account.

When identifiable intangibles are sold, or a permanent diminution in value occurs, the profit or loss should be taken to the profit-and-loss account as an extraordinary item.

Full disclosure of the basis of valuation, including details of independent valuations, date of valuation, (after-tax) discount rate used, expected life and precise write-off method, should be made in the annual accounts.

The costs of internally generated intangibles may be impossible to identify and often bear little relationship to the value of the intangible. For instance, a million-dollar advertising campaign to create a brand name may fail but a $50,000 campaign may succeed beyond expectations and create a brand name worth a million dollars.

Also, it may be several years before the value of an intangible becomes apparent.

Therefore, the cost of creating intangibles should continue to be expensed as at present. Identifiable intangibles should be valued periodically (say, tri-annually), as is currently the practice with land and buildings, and recorded as an increase or decrease in identifiable intangible assets and an increase or decrease in the asset revaluation reserve. □

MEMBERS OF THE SUB-COMMITTEE

The subcommittee set up to review the proposals on accounting for intangibles was chaired by Wayne Lonergan, a partner in Coopers & Lybrand.

Other members were Doug Little (Bain and Company Limited), Bill Neill (Frank Clune & Sons), Brian Saunders (Boral Limited) and Frank Mattiussi (Hambros Australia Limited).

Brand names: can you measure their lifespan?