Giving substance to intangibles

How we can do better than IAS 38

Intangible assets are a major issue for the accounting profession and for investors but they have generally received little attention in financial reports or from regulators. WAYNE LONERGAN, DONALD STOKES and PETER WELLS argue that the accounting profession and regulators should be directing their attention towards understanding the nature and true value of these assets.

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Commentators have attributed the current period of worldwide economic growth and sustained productivity improvements to technology or the "new economy". Further, there have been suggestions of a structural productivity revolution driven by information technology which permeates all aspects of company operations: the nature of goods and services produced, production techniques, distribution methods and the overall management of companies. In Australia, evidence of this development is provided by the Productivity Commission, which suggests that productivity improvements have increased from a long-term trend of 1.4% to 2.4% during the 1990s.

This suggests that investments in technological assets, and intangible assets more generally, are becoming increasingly significant for companies and are the primary determinants of investment direction not just for companies, but also investors. However, this is generally not reflected in financial reports, with most accounting disclosures and regulations relating to tangible assets and not intangibles. This had led to claims in the professional press that if financial reporting ignores intangible assets it risks becoming increasingly irrelevant for decision-making (eg, Elliot and Jacobsen 1991, Jenkins 1994).

An exception to the general non-recognition of intangible assets arises in Australia where, following AASB 1013 *Accounting for Goodwill*[1], many firms voluntarily recognise these assets in their financial statements. Central to this has been the revaluation of such assets under AASB 1010 *Accounting for the Revaluation of Non-Current Assets*. The revaluation of intangible assets is problematic because of their nebulous nature, and this is reflected in the range of valuation methods used:

- comparable market transactions;
- historical or replacement cost; and,
- economic benefits methods which include
  - gross product differential,
  - excess profits,
  - relief from royalty, and
  - marginal cashflows.

Further contributing to the maintenance of identifiable intangible assets in the financial statements is the decision frequently made not to amortise these assets. Tabakoff (1999) notes that for the Top 200 Australian companies, intangible assets amounted to $43.5 billion in 1998, and that 91% ($39.7 billion) of these assets are not being depreciated. The decision not to amortise the assets is based on the claim that the assets have an infinite life, thereby avoiding the requirements of AASB 1021 *Depreciation*. This has attracted the attention of the Australian Securities and Investments Commission, which has expressed concern that claims of infinite asset lives did not at times appear to be supported by the circumstances.[2]

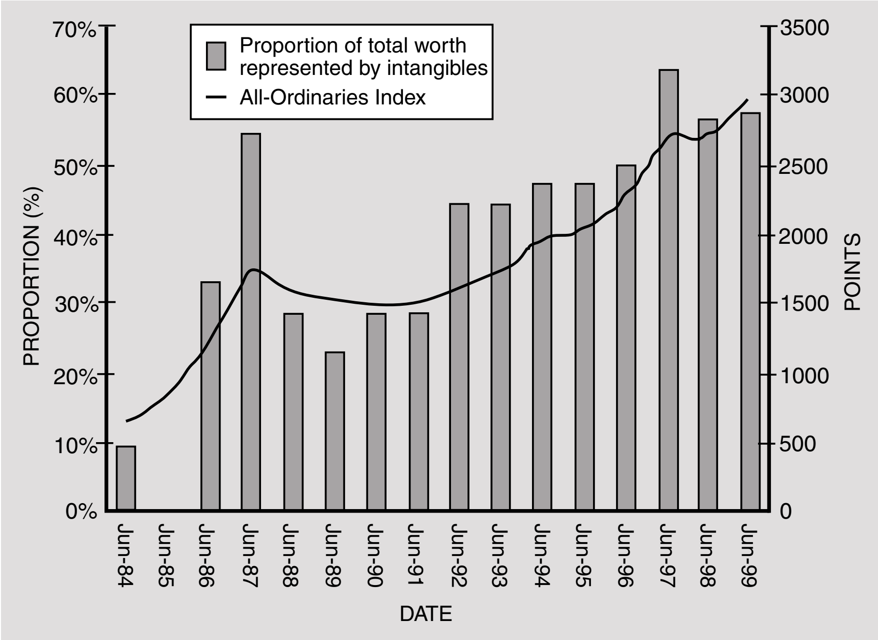
In addition, a guidance statement issued by the Australian Accounting Research Foundation, Accounting Interpretation AI 1 *Amortisation of Intangible Assets* (June 1999), states that at the time identifiable intangible assets are initially recognised and/or upon subsequent revaluation, most of them will be captured by the provisions relating to limited useful lives in AAS 4 and AASB 1021 *Depreciation of Non-Current Assets*.

Further, the practice of not amortising identifiable intangible assets is in marked contrast to the requirements relating to unidentified intangible assets (ie, goodwill) which, under AASB 1013, must be amortised over a period not exceeding 20 years. Interestingly, the decisions to recognise identifiable intangible assets rather than goodwill, and not to amortise such assets, remain deep-seated despite the fact that amortisation does not affect cashflows and cannot affect share values.

While a variety of practices have been applied to valuing and amortising such assets, there is empirical support for their continued recognition and revaluation. Lonergan, Stokes and Wells (2000) and Barth and Clinch (1998) consider intangible assets generally and find that accounting recognition of such assets and their revaluation is value-relevant for equity investors. These results arise notwithstanding:

- many companies electing not to disclose their identifiable intangible assets;
- those choosing to disclose identifiable intangible assets revaluing them infrequently; and,
- the valuation methodologies for identifiable intangible assets not being widely understood.

FIGURE 1 **Intangible assets (calculated as excess of market value over book value) v All-Ordinaries Index**



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With respect to the last point, the potential for error was highlighted in the ASIC (1998) report on Burns Philp and Company Ltd.

While the above two studies have focused on intangible assets generally, consideration has also been given to the value-relevance of a range of specific intangible assets or related disclosures, including:

- research and development costs (Lev and Sougiannis 1996);
- patent data (Hirschey, Richardson and Scholz 1998);
- software development costs (Aboody and Lev 1998);
- brand names (Barth, Clement, Foster and Kasznik 1998); and,
- advertising expenditure (Hirschey 1982).

The consistent theme in the research findings is that disclosures concerning the intangible assets of the company are value-relevant, and that accountants and regulators should consider capturing information about these assets in financial statements.

Compounding the problem is the increasing magnitude of intangible assets. This is captured in Figure 1, which charts the relative growth of intangible assets (calculated as the excess of market value over book value) and the All-Ordinaries index between June 1984 and June 1999. It is notable that intangible assets now outweigh tangible assets, and that there is a high correlation (with a 99% confidence level) between the growth in intangible assets and the All-Ordinaries index. This reinforces evidence in Lonergan, Stokes and Wells (2000) which shows a persistent decline in the ratio of book value of net tangible assets over firm market values, so that this ratio is now significantly below one. This is consistent with investors' and analysts' experience of the increasing importance of brand names, licences, mastheads and similar assets on company values and the increasing service-industry and technology focus of the Australian economy.

Notwithstanding the increasing strategic importance and magnitude of intangible assets, they have received scant attention from regulators. An examination of all accounting standards issued by the ASRB and AASB reveals that:

- there are only two specific accounting standards on intangible assets, and those deal only with goodwill and research and development;
- if standard-setting effort is measured by the number of standards issued, then only 5% of standard-setting effort has been directed at what is now 66% of value (an alternative way of looking at this is that 95% of standard-setting effort has been directed at issues affecting less than half of corporate net worth);
- the two standards dealing with intangibles were issued long ago, in 1987 (R&D) and 1988 (goodwill — although this was updated for amortisation period in 1996);
- there is no specific standard covering the majority of identifiable intangible assets;
- much of accounting-standard focus has been on disclosure issues; and
- despite the obvious importance of intangible asset values, other less important issues have been revised on a number of occasions while issues relating to intangibles have been largely ignored (or appear to have been put in the "too hard" basket).

This lack of attention seems set to change with the AASB announcing the intention to commence a project on intangible assets.[3] Internationally, IAS 38 has been issued, and continued application of existing accounting practices for identifiable intangible assets is threatened by the prospect that the provisions of IAS 38 will be imported into a new Australian standard under a policy of international harmonisation.[4] IAS 38 can be characterised as adopting a "scorched earth" approach to intangible assets, with some of its key features being:

- an intangible asset can only be recognised initially, at cost, in the financial statements and only if:
  (a) the asset meets the definition of an intangible asset. Specifically, there must be an identifiable asset that is controlled and clearly distinguishable from goodwill,
  (b) it is probable that the future economic benefits attributable to the asset will flow to the enterprise, and
  (c) the cost of the asset can be measured reliably.

If an intangible item does not meet both the definition and the criteria for recognition, expenditure on this item must be recognised as an expense when it is incurred. The recognition criteria dictate that all expenditure on research, start-up costs, training and advertising must be recognised as an expense. Further, it specifically prohibits the recognition of internally generated goodwill, brands, mastheads, publishing titles, customer lists and items similar in substance.

- With respect to business acquisitions, if an intangible item does not meet both the definition and the criteria for the recognition for an intangible asset, the expenditure on this item should form part of the amount attributed to goodwill. As such, purchased R&D-in-progress would be recognised as goodwill (not research and development) and amortised accordingly.

- After initial recognition in the financial statements, an intangible asset should be measured under one of the following two treatments:
  (d) benchmark treatment: historical cost[5] less any amortisation and impairment losses, or
  (e) revalued amount (based on fair value) less any subsequent amortisation and impairment losses. Revaluation of intangible assets is permitted only if fair value can be determined by reference to an active market. Active markets are expected to continue to be rare for many intangible assets.

- Intangible assets should be amortised over the best estimate of their useful life. Assignment of an infinite useful life to an intangible asset is not permitted and there is a rebuttable presumption that the useful life of an intangible asset will not exceed 20 years from the date when the asset is available.

- This latter rebuttable presumption needs to be supported by appropriate disclosure.

Implementation of an Australian accounting standard based substantially on IAS 38 *Accounting for Intangible Assets* will essentially align accounting treatments for identifiable and unidentifiable intangible assets (such as goodwill). However, in doing so it will significantly discourage the accounting recognition of intangible asset values and constrain the accounting practices adopted for such assets. For example, amounts disclosed will be reduced because of restrictions on the revaluation of intangible assets and compulsory amortisation over a maximum period.

We are at an interesting point in the development of the regulation of reporting for intangible assets. Adoption of a standard based on IAS 38 will encourage a reduction in intangible asset disclosures, and it could increase the reliability of the (reduced) information set contained in financial statements. However, our initial empirical research indicates that effectively dismissing intangible assets, as IAS 38 does, will decrease the overall relevance of financial reports. If the information must be sought from alternative sources this could lead to a loss of economic efficiency and, in the extreme, the absence of such information could contribute to an uninformed market.

Rather than simply writing off intangible assets as implied by IAS 38 and effectively discouraging disclosure, and hence reducing the flow of information to investors, accountants and regulators should be addressing a number of issues:

- what is the nature of intangible assets;
- how intangible assets generate value or contribute to the value of the firm;
- how firms are managing (creating and maintaining) intangible assets;
- how identifiable intangibles (eg, brands, licences, etc) can be reliably distinguished from goodwill;
- what factors drive the voluntary choice of methods of accounting recognition, amortisation and revaluation of classes of intangible assets;

- how intangible asset disclosures maintain or enhance the value-relevance of financial reports;
- what accounting practices would enhance the value relevance of financial statement information; and,
- how the serious adverse capital gains tax and other adverse tax consequences of inadequate valuation methods can be avoided.

Addressing these issues will provide an opportunity for an informed debate on proposed regulation for intangible assets and assist with a considered analysis of the costs and benefits of the proposals. Such an analysis is central to the CLERP (Commonwealth Law Economic Reform Program) reforms that established the new accounting standard-setting framework in Australia. At a minimum, ignoring the current evidence on the value-relevance of the voluntary disclosures of intangibles that have been made in the absence of regulatory restrictions would be inconsistent with the reforms, and a disappointing start to the new accounting framework in Australia.

The authors appreciate the financial support of PricewaterhouseCoopers, Securities Industry Research Centre for Asia Pacific (SIRCA) and the School of Accounting, University of Technology, Sydney.

NOTES

1. Whittred, Zimmer and Taylor (2000) discuss the historical development of accounting for identifiable intangible assets.

2. ASIC Media Release 99.479, “Areas of concern remain in financial reporting”.

3. Australian Accounting Standards Board, Press Release 21 June 2000, “AASB to discuss intangibles”.

4. Australian Accounting Standards Board, Policy Statement 6 *International Harmonisation Policy*, paras 2.1 and 2.2 require the development of an internationally accepted set of accounting standards in Australia. Practically, this has involved a program of making Australian Accounting standards consistent with (but not identical to) International Accounting standards. This convergence has been reinforced by legislation amendments.

5. IAS accounting standards are more historic-cost-oriented than are Australian standards.

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FPA gives green light to SIA graduates

The Financial Planning Association (FPA) has recently advised that it will recognise the SIA’s Diploma of Financial Advising to gain entry into the Certified Financial Planning (CFP) program conducted through the University of Western Sydney (UWS).

CFP is a trademark controlled in Australia by the FPA. Except for people gaining CFP under transitional arrangements, applicants need to complete an approved course of study, either four or five subjects at UWS, and meet industry experience requirements.

While graduates of the Graduate Diploma in Financial Planning and Graduate Diploma in Applied Finance and Investment have always had access to the CFP program, until this recent decision open-entry students wanting CFP could complete three subjects with the SIA and then had to transfer to the DFP. Now our students can complete our DFA and gain entry to the CFP program.

The DFA provides students with the ability to tailor their subject choices and their mode of study to suit their needs, as well as having the advantage of studying with the SIA.

The Institute is receiving positive reactions from all regions on this initiative.