

International accounting standards under pressure

Australia was quick to champion the cause of international accounting standards, but now there is growing concern that we jumped on board without thinking the issues through. **WAYNE LONERGAN** and **HUNG CHU** explain.

The FRC/AASB policy of mandatory adopting of IFRS from 1 January 2001 has a number of serious and adverse consequences.

One of the most serious is the reduced disclosure of price sensitive information about the value of identifiable intangible assets, in particular those identifiable assets that would be – but for the IFRS prohibition – recognised or revalued.

The practice of recognising and revaluing non-current assets, including identifiable intangible assets, is a long-established generally accepted accounting practice in Australia.

This practice has been permitted by the AASB and its predecessor equivalents for many years.

However, the proposed adoption of the most recent version of IFRS 1 and IFRS 38 has these effects:

- (a) Internally generated identifiable intangible assets will not be recognised except in the rare circumstances that there is an active market for them;
- (b) Existing revaluations of identifiable intangible assets will have to be reversed (except where it is impractical to do so);
- (c) Future revaluations of internally generated or acquired identifiable intangible assets will be prohibited (except in the rare circumstances that there is an active market for them, for example, taxi licences).

Goodwill concessions won't compensate

The revised IFRS standard on goodwill differs from the long-established present AASB standard (which is

basically similar to other accounting standards throughout the world in terms of limited life/ amortisation requirements). From 2005, goodwill will no longer be subject to annual amortisation. Instead a recoverable amount test (called an impairment test under IFRS) will be applied each year.

This change has a number of important consequences:

- (a) Companies may have to make impairment write-downs when interest rates rise or industry economic conditions deteriorate. Such impairment write-downs will exacerbate profit reductions caused by the same factors;
- (b) The long-established Australian practice of accounting arbitrage from goodwill in favour of identifiable intangible assets will, in future, be reversed;
- (c) Companies who have attributed substantial values to internally-generated identifiable intangibles, or who have revalued purchased identifiable intangibles, will have to write these values off.

The end result will be:

- (a) Some companies will have significantly reduced or even negative shareholders funds;
- (b) Unnecessary problems will be created in maintaining (and sometimes in even paying) dividends;
- (c) Some companies will be in breach of borrowing covenants or thin capitalisation tax rules;
- (d) Valuable information about intangible asset values will no longer be available to investors.

**WAYNE
LONERGAN FSIA
DR HUNG CHU**
Lonergan Edwards
& Associates
Limited



Information about intangible assets is value-relevant

Findings from a number of academic studies conducted in Australia and overseas consistently suggest that capitalisation and revaluation of intangible assets including identifiable intangible assets are relevant to firm valuations.

For example, examining the 100 largest companies listed on the Australian Stock Exchange (ASX), as measured by market value of equity as of 30 June 1996, and a random sample of 250 firms selected from the remaining Australian firms traded on the ASX with market value of equity greater than A\$10 million from the period between 1991 and 1995, Barth and Clinch (1998) show that revalued intangible assets are consistently significantly positively associated with share prices.

Godfrey and Koh (2001) tested whether capitalisation of intangible assets, either in aggregate or by specific category of intangible assets, affects firm valuations. Using a sample of 172 Australian firms with reported intangible assets in 1999, the study found capitalised intangible assets, as a whole, provide information that is relevant for investors in valuing firms.

A more significant finding of the study is that when capitalised intangible assets are disaggregated into goodwill, R&D and other identifiable intangible assets, both goodwill and other identifiable intangible assets provide relevant valuation information incremental to other balance sheet items.

These findings are hardly surprising, given that intangible assets have become increasingly important components of firm value. Studying 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, Lonergan, Stokes and Wells (2000a) found that:

- (a) On average, intangible assets now outweigh tangible assets;
- (b) There is a high correlation (with a 99% confidence level) between the growth in intangible assets and the All-Ordinaries index.

This is also consistent with evidence in Lonergan, Stokes and Wells (2000b) 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.

De-recognition of intangible assets will cause serious adverse consequences

Given that capitalised and re-valued intangible assets are value-relevant and they form important (for many companies, the most important) components of firm value, the de-recognition of many existing intangible assets, particularly revalued identifiable intangible assets caused by the compulsory adoption of IAS 38 in Australia will decrease the usefulness of financial reports.

The loss of price-sensitive information from financial statements will force investors to seek the omitted information from other sources. Using analysts' ratings of firms' disclosures, Gelb (2002) found that firms with higher levels of intangible assets (which are not allowed to be recognised in their financial reports) are more likely to receive significantly higher ratings for their investor relations programs or voluntary publications than for their annual reports.

These findings suggest that firms with higher levels of intangible assets emphasise supplemental disclosures because mandated accounting disclosures inadequately present their financial position and performance.

Notwithstanding the voluntary supplemental disclosure of information about intangible assets, the non-recognition of these assets still cause investors to incur costs in understanding the implication of the disclosed information for the value of the non-recognised assets.

Such an understanding would need to be sought from information processing intermediaries such as analysts at a cost. Consistent with this, Barth, Kasznik and McNichols and Kasznik (2000) found that analyst coverage is greater for firms with more intangible assets.

Because the search for and

acquisition of information about the derecognised intangible assets, which would otherwise be readily available from financial statements, can be time-consuming and costly, the derecognition of these assets could contribute to a greater level of information asymmetry between insiders and outside investors in intangible asset intensive firms. This in turn leads to:

- (a) A higher level of uncertainty about firm value and higher cost of capital particularly for new productive investments;
- (b) An "un-level playing field" for investors, particularly those who are less informed and trade for liquidity reasons. For example, Aboody and Lev (2000) found that trades by insiders in R&D intensive firms were three to four times as profitable as were trades by insiders in non-R&D intensive firms.

It naturally follows that one of the outcomes of automatically adopting IAS 1 and IAS 38 in Australia would be inconsistent with the regulators' general goals of reducing cost of capital for new productive investments and maintaining a level playing field for all investors.

Are the IASB's grounds valid?

Notwithstanding consistent market evidence on the value relevance of capitalisation and revaluation of identifiable intangible assets, the IASB does not allow internally generated identifiable intangible assets to be recognised or revalued (except in the rare circumstance where there is an active market) in financial statements. IASB adopted this stringent approach to accounting for intangible assets mainly on the ground that the value of these assets cannot be reliably measured.

That is, lack of reliability has actually overwhelmed relevance justifying, in the IASB's view, the non-recognition of these assets.

While the value of internally generated intangible assets is sometimes subject to a degree of measurement uncertainty, reliability in its own right is not a valid reason for not according these assets financial

statement recognition. There are several reasons why.

Firstly, accounting often involves making estimates, and therefore it is insufficient to reject the recognition of an estimated fair value because that amount represents an estimate rather than a precise estimate.

Secondly, because both relevance and reliability are important characteristics of financial information, basing recognition decision on reliability alone is too simplistic. Barth, Clinch and Shibano (2001) show that reliability relative to relevance, rather than reliability per se, is a key attribute in determining whether recognition of an accounting item results in greater or lower price information.

Thirdly, the value of intangible assets estimated by either independent valuers or company directors can be sufficiently reliable to be reflected in share prices and returns.

Barth, Clement, Foster and Kasznik (1998) examined the association between brand values estimates and share prices of firms owning the brands for a sample of over 330 brands owned by firms in a variety of industries. The brand value estimates used in this study were derived by FinancialWorld (FW) using a methodology adopted by the brand valuation consulting firm, Interbrand Ltd. The study shows that:

- (a) Share prices are positively related to brand value estimates;
- (b) Annual share returns are positively related to year-to-year changes in brand value estimates.

These findings support the view that the value of intangible assets can be estimated by independent valuers, and such value estimates are sufficiently reliable to be impounded into share prices and returns. In discussing the implications of their findings for accounting standard setting, the authors observe: "... these findings call into question concerns of those who believe that brand value estimates are too unreliable to be the basis for recognition as an intangible accounting asset".

Regarding source of value estimates, Barth and Clinch (1998) found little evidence indicating independent

appraiser-based revaluation amounts for intangible assets are value relevant more often than director-based amounts.

Finally, even when directors' discretionary valuations of intangible assets are subject to biases, there is evidence which suggests that investors are not misled by the lack of their reliability in their value estimates (although this does not excuse them from doing the valuation correctly).

For example, Kallapur and Kwan (2002) examined whether the market capitalisation rates of brand assets differ for a sample of UK firms that have high and low incentives to bias the recognised brand amounts.

Firms with high incentives to bias their discretionary valuations of brand assets are those characterised by managers' desire to discourage shareholder approval for acquisitions/disposals or reduce apparent financial leverage. If firms with high contracting incentives overvalue brands or introduce greater measurement uncertainty then their brand capitalisation rates should be lower.

Consistent with this proposition, empirical results in their study suggest that the brand capitalisation rates for firms with high contracting incentives are significantly lower than those for firms with low contracting incentives.

These findings suggest that while managers' discretionary valuations of intangible assets recognised in financial statements might not always be reliable, particularly for firms with high contracting incentives, the markets do seem capable of seeing through the differences in reliability.

Additional disclosure won't be a solution

Unfortunately, the adverse consequences caused by the IASB insisting on de-recognition of existing identifiable intangible assets cannot be simply fixed by additional disclosure.

This is because not only does disclosure about identifiable intangible asset values, affect share price values but that it is only when such asset values are reflected in company accounts, as opposed to additional note

disclosure, that share values properly reflect such information. That is, additional note disclosure is not an adequate substitution for balance sheet recognition. This proposition has been confirmed in several studies.

For example, Harper, Mister and Strawser (1987) found that a significantly greater number of commercial bankers surveyed included the pension obligation in the numerator of a debt / equity ratio when the pension information was presented in a balance sheet than when the same information was presented as a supplemental note to the balance sheet.

Consistent with their prior study, Harper, Mister and Strawser (1991) also found that lenders were more likely to perceive an unfunded post-retirement benefit as a component of debt when it was recognised in the balance sheet as a liability than when the same item was accorded supplemental footnote disclosure.

The findings from these experimental studies support the view that the method of reporting a liability within the balance sheet can affect the way in which users of financial statement perceive and measure a company's debt.

Not only does the method of reporting an accounting item influence financial statement users' perceptions, it can result in differential pricing in the market.

Boody (1996) found that oil and gas firms recognising a write-down in connection with a decrease in oil prices experience a negative stock market reaction, whereas there was no significant stock market reaction for firms disclosing in its footnotes, but not recognising a write-down.

Barth, Clinch and Shibano (2001) provide a theoretical explanation for the differing impacts of recognition and disclosure on the informativeness of share prices. Their explanation is based on the proposition that understanding disclosures requires accounting expertise beyond that needed to understand recognised amounts, and that expertise acquisition is costly.

The cost and benefit trade-off facing investors in their expertise acquisition choice differ between recognition and

disclosure regimes. The implication of this is that whether an asset is recognised or disclosed can affect the proportion of investors acquiring expertise to understand the accounting disclosure and, consequently, the extent to which fundamental information about a firm's value is impounded into its share price, ie the informativeness of share prices.

Where to from here?

High level representations were, being made to the IASB to at least grandfather the existing revaluations. Given other IASB concessions to corporate pressure in other areas (eg grandfathering of pooling, existing derivative values, and de-recognition) this was hardly a big ask. However, the Australian request was rejected.

Most of the IASB constituents come from a deeply entrenched historic cost focus. As a result they are both unfamiliar with revaluation issues and profoundly sceptical of many of the values attributed to revalued intangibles. (That the IASB happily accept the very same valuation methodologies applied to acquisition accounting and impairment testing does not seem to strike them as inconsistent).

The IASB approach to identifiable intangible assets is inconsistent with both the approach taken with acquisition accounting (which mandates that all underlying assets be fair valued in a process which requires them to be valued) and with their push to fair value accounting in other standards including derivatives, SGARA's impairment testing, financial instruments, employee options, etc.

In essence, while the IASB is moving gradually to fair value measurement, they have taken the opposite stance on identifiable intangible assets (ie no or very few can be recognised or revalued plus reverse existing recognition/revaluations). Given that:

- (a) The aim of financial reporting is to produce information that is useful to users;
- (b) Identifiable intangible assets clearly meet the conceptual framework definition of an asset (ie control over future economic resources);

- (c) Intangible asset values represent the majority of asset values in most listed company balance sheets;
- (d) Information about identifiable intangible asset values is clearly price sensitive; and
- (e) The value of identifiable intangible assets estimated by independent appraisers is sufficiently reliable to be impounded into share prices.

It is clear that the present IASB view on identifiable intangible assets values is not sustainable. It would be a serious indictment on the IASB, and indeed the whole concept of mandatory adoption of IFRS, if the IASB did not rethink its approach to this important issue.

That the IASB workload may not permit it to review this matter for some years is hardly an acceptable excuse. It will be to the detriment of financial reporting, however, unless the IASB gives ground on these important issues.

REFERENCES

Aboddy, D., "Recognition versus disclosure in the Oil and Gas Industry", *Journal of Accounting Research* (Supplement 1997) 21-32.

Aboddy, D., and B. Lev., (2000), "Information Asymmetry, R&D, and Insiders Gains", *Journal of Finance*, 55, pp 2747-2766.

Barth, M, M. Clement, G. Foster and R. Kasznik, (1998), "Brand Values and Capital Market Valuation", *Review of Accounting Studies*, 3 pp 41-68.

Barth, M., and G. Clinch, (1998) "Revalued financial, tangible and intangible assets : Associations with share prices and non market based value estimates", *Journal of Accounting Research* 36 (Supp.), pp 19-233.

Barth, M., R. Kasznik, and M. McNichols (2001), "Analyst coverage and intangible assets", *Journal of Accounting Research*, 39, 1.

Barth, M., C. Clinch and T. Shibano, (2001), "Market Effects of Recognition and Disclosure", working paper, Stanford University.

Gelb, R., (2002) "Intangible Assets and Firms' Disclosures : An Empirical Investigation", *Journal of Business Finance and Accounting*, 29, pp 457-476.

Godfrey, J., and P. Koh, (2001), "The Relevance to Firm Valuation of Capitalising Intangible assets in Total and by Category", *Australian Accounting Review*, 11, pp 39-48.

Harper, R., W. Mister, and J. Strawser, (1987), "The Impact of New Pension Disclosure Rules on Perceptions of Debt", *Journal of Accounting Research* (Autumn): 327-30,

Harper, R., W. Mister, and J. Strawser, (1991), "The Effect of Recognition versus Disclosure of Unfounded Postretirement Benefits on Lenders' Perceptions of Debt" *Accounting Horizons* (September): 50-56.

Kallapur, S., and S. Kwan, (2002), "The Value Relevance and Reliability of Brand Assets Recognised by UK Firms", working paper, Purdue University.

Loneragan, W., D. Stokes and P. Wells, (2000) "Giving Substance to Intangibles: How we can do better than IAS 38", *JASSA*, 4, Summer 2000.

Loneragan, W., D. Stokes and P. Wells (2000), "The Changing Value Relevance of Net Assets and Earnings", Working paper, Securities Industry Research Centre for Asia Pacific.

A service for JASSA contributors JASSA REPRINTS

Authors may order reprints of their articles as published in JASSA.
For details of costs and quantities, contact the publisher at:

Hardie Grant Magazines 12 Claremont Street, South Yarra, VIC. 3141
Phone: 03 9827 8377 Fax: 03 9827 8766