The intangible issue

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1 Defining the audience

As part of a quality improvement drive Tilburg University shortly introduced the concept of 'student oriented education'. Although I never understood what other orientations were feasible in the case of education, today I will abide by this movement. Therefore my focus will be on the 'student' population in front of me. Under the audience is a well esteemed group of experts in the field of financial accounting. However a majority group of others has to be served as well together with a group of semi-experts. My aim is to make the 'others' aware of a major problem area in the discipline of financial accounting. My challenge is to do so in the utmost simple wording.

For the experts this will create an excellent opportunity to relax. Hopefully this relaxed state of mind is proper breeding ground for some of them to let new ideas flourish!

2 Defining 'the gap'

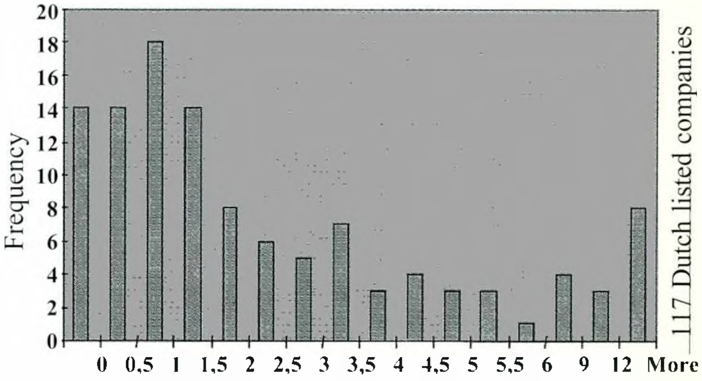
The major problem area we are concerned about is the ever widening gap between bookvalue and market value of enterprises. As a start up I will demonstrate this by showing a few figures from four companies listed on the Amsterdam Stock Exchange(AEX). The figures (x *f* 1.000.000) are taken from their 1997 Annual Reports and the AEX price list by the end of 1997 (Table 1).

Table 1: Companies listed on the Amsterdam Stock Exchange

	Unilever	*KBB*	*Reed Elsevier*	*Wolters Kluwer*
Intangible assets	0	0	8.353	6.031
Tangible assets				
% liabilities	24.734	707	-3.363	-4.217
Equity	24.734	707	4.990	1.814
Equity per share	13.7	61.97	4.36	17.58
Share price	125.3	125.50	32.8	261.9
Gap	8 x	2 x	6.5 x	14 x

Within this small sample we discover a wide range of numbers reflecting the per company 'gap' between its bookvalue, represented by Equity per share and its market value, represented by its Share price, measured simultaneously. In passing by I would like to highlight also the composition of equity: Unilever and KBB are free from any intangibles on their balance sheets whereas Reed Elsevier and Wolters Kluwer would even end up with negative equity figures without capitalising intangibles. We will come back to this later.

From our small sample we now turn to the core of AEX listed companies. Graph 1 is a



Graph 1: Histogram gap/equity

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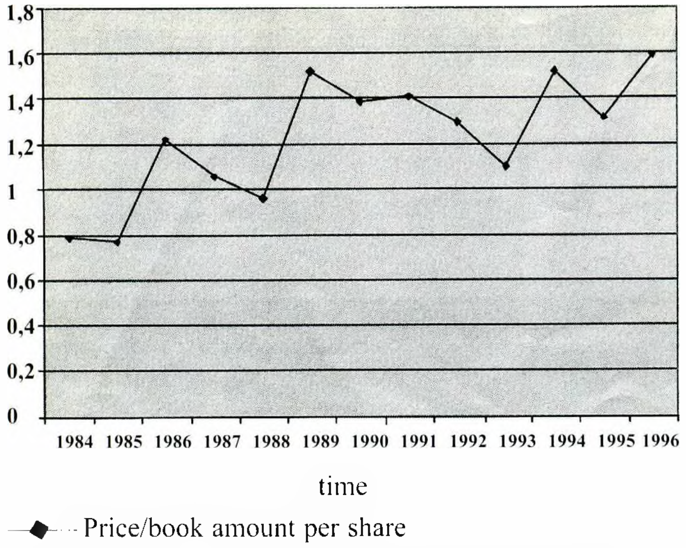

Graph 2: Ratio market to book value in the Netherlands

Histogram of the gap/equity relationship for 117 of those, calculated on the same basis as above. The four companies as scrutinised are no exception: as an average the gap between market and bookvalue is about 3,6 times bookvalue. In other words bookvalue could grow 3,6 times and still remain within the range of market value for the same company. Only a minority of 14 out of 117 companies do show a negative gap, which means equity exceeds market value. Otherwise the 'spread' is between 0 and 18 times.

Further investigation shows that the 'gap' between market and book value seems to be widening as is demonstrated by Graph 2, showing similar figures for an aggregate sample over a period of 13 years (1984-1996). This is a sample comprising 750 observations over the period.

2.1 Filling the gap

So, let us take it for a moment that a structural gap exists between market value and book value of firms and that data from other countries would not substantially change this first impression. A proper way to visualise this is the empty beer glass with foam left at the top and a decent pile of 'assets minus liabilities' at the bottom. The foam edge does represent the range of values attached by the market to a company over time. As has been shown in the last few months in 1998 share prices can be rather volatile making it impossible to put a robust figure on the company's market value. However, nowadays even in a minimum position the market value normally still exceeds book value to a considerable amount. Conventional accounting would not fill the gap, simply call it 'internally generated goodwill' and on that basis preclude its capitalisation.

If we really want to fill the gap two routes lay open: revalue existing assets or add new assets. Although some favour revaluation of assets to market or fair value, in my view the obvious way to fill the gap is to put more assets on the balance sheet, or in official wording: by recognising assets that are not recognised now. This would keep us fully within the historic cost convention and the existing conceptual framework for financial accounting, as I will explain in the next paragraph.

3 Conceptual framework, reading backwards?

Let's have a closer look at the concept of an asset. There is a substantial difference between the meaning of the English word 'asset' and the continental expression 'actief' or 'activa' in plural. This may be demonstrated by the English expression 'he (or she) is an asset to the company' which as such can not be translated into Dutch. Having learned the difference we now simply follow the definition generally accepted in world-wide standard setting (IASC 1989): (an asset is)

- a resource,
- controlled by the entity,
- as a result of a past event, (from which)
- future benefits, (are expected to)
- flow to the enterprise.

Just looking at this broad definition one would not have the slightest idea that intangible assets are heavily discriminated against tangible ones. Apparently some other mechanism is narrowing down the wide range of potential assets to the limited categories of assets actually showing up in our balance sheets. This is not a matter of concept/definition but rather of the more pragmatic criteria for recognition. Here the level of control and reliability of measurement come into play more than relevance of the item. There is a general concern that recognition of intangibles would in fact mean that internally generated goodwill is capitalised. This is, however, a rather circular way of reasoning: by capitalising the proper intangible assets probably the whole idea of goodwill could be banned from the accounting area. If an asset is a source of 'economic benefit' maybe we can read that backwards also: no economic benefit without its source(s). Conventional accounting starts by recognising the sources embodied in tangible assets leaving easily aside sources of economic benefits that are embodied in intangible assets. It is highly doubtful whether this convention does reflect economic reality. One could argue that many of today's tangible assets would never pass the recognition test if their intangible counterparts would have been capitalised in the first place.

The new IAS (38) on Intangible Assets (IASC 1998) specifically excludes a number of such intangible counterparts when generated internally: brands, publishing titles, customer lists and items similar in substance. Here the standard setter does not allow the application of judgement based on general criteria but directly precludes capitalisation of a substantial part of intangibles. The reason given: such expenditure cannot be distinguished from the cost of developing the business as a whole. Why is it that expenditure on building a plant for producing cosmetics can be distinguished from developing the business as a whole and expenditure on marketing a new brand in cosmetics can not?

Under the category of intangibles we discover areas of interest that are typical for modern management such as software, brands, research and development, market share, human capital etc. etc. It is clear enough that investments in these areas are substantial nowadays, they are a matter of success or failure for modern industry and normally a substantial part of management time and attention will be spent in this area. Yet under present accounting conventions the substantial cash outlays in this direction are simply reported under period cost in stead of being capitalised as investments for future profit.

4 The prudence concept

In the meantime the conclusion should not be that there is no limit to asset recognition, be it tangible or intangible. There is the prudence concept in the first place. Recognition should result in bookvalues only that are likely to be turned into cash within the useful life of related assets. As long as the gap shows a magnitude as it does today for most enterprises, this can be easily handled by the insertion of a safety zone below the range of market values that a company has shown in recent years. Using the beer glass metaphor again, there is plenty of room to artificially enlarge the foam edge on behalf of a sound prudence policy.

Furthermore there is a requirement of testing for impairment and taking losses where necessary. This requirement is generally accepted in accounting and only recently confirmed by an elaborated standard: IAS 36. Management of a reporting entity should assess whether the carrying amount of an asset would exceed its 'value in use' as determined by the 'cash generating capacity' of the assets concerned. This not a very burdensome requirement today as all earning capacity is allocated to a limited set of assets only. For example: impairment of a factory is out of the question as long as the brand name of its products takes care of selling it. If depreciation on capitalised brand name investments would have to be allocated, impairment might follow suit. Management does not like impairment neither do standard setters.

A typical example is that of the Blackpool football team, introduced by Terry Smith (Smith 1992). Mr Michael Renshall is quoted here, an accounting guru, former chairman of the Accounting Standards Committee in the UK. Back in 1953 Blackpool won the FA Cup and accordingly the club would have appeared very attractive to anyone wanting to buy the club at that time. 'There would have been a lot of goodwill in the price someone would have paid then' Mr Renshall stated 'But it is obvious now that the goodwill did not have an indefinite life' (Blackpool is now in Division Three and has not won the FA Cup since). What we learn from the example is in the first place the self-evident wisdom of a standard setting guru. Mr Renshall without any further argument advocates an accounting culture where company accounts in a period of success do not look different from those in less prosperous times. Clear enough Blackpool management has taken a similar position: Don't capitalise whenever you run a serious risk of impairment! Common thinking in financial accounting is neglecting the information value of impairment.

In conclusion, the only way to full recognition of intangibles is through an overall change in attitude, a change towards 'impairment accounting'. Instead of simply expensing most of their cash outlays on intangibles immediately, companies should be encouraged to capitalise them and consequently enter into a program of yearly selection of less successful investments in this area. In doing so they would largely contribute in management transparency, so strongly advocated today. A perfect manual is available in IAS 36 'Impairment of assets' (IASC 1998).

5 Merger and acquisition

Above we have drawn a picture of general reluctance to recognise intangibles on the balance sheets. Now we have to explain the examples shown at the start of this lecture as only Unilever and KBB seem to fit in this picture. The two publishing companies carry huge amounts of intangible assets on their balance sheets and therefore seem to contradict this general reluctance.

Fact is that capitalisation of intangible publishing rights in the publishing industry is solely triggered by mergers and acquisitions. Whatever the accounting treatment of assets and resulting bookvalue of the target company, in case of an acquisition a certain price is paid on the level of market value. Consequently our gap does appear in the accounts of the acquirer who, by stripping it down to intangibles automatically reduces the amount of goodwill to be capitalised. Indeed standard setters are more willing to accept capitalisation of intangibles acquired in a merger or acquisition than those acquired or built up by a stand-alone firm. This still does not explain the difference we noticed between e.g. Unilever and Reed Elsevier as Unilever in recent years has been even more active in the acquisition market than publisher Reed Elsevier. In the acquisitions of both companies substantial amounts have been included for intangible assets like brands and publishing titles respectively. However in the case of Unilever there are always some tangible assets (like factories) involved, publishers on the other hand do not need factories since printing is mainly outsourced. As clearly demonstrated by the Reed Elsevier and Wolters Kluwer examples without capitalisation of acquired intangibles both companies would have shown a negative equity.

Apparently the accounting treatment of intangibles depends largely on the circumstances and less so on the nature of the asset involved. This again does not look like a strong and consistent accounting method.

6 Management accounting

To complete our observations on intangible assets we have to turn to the internal system of management accounting underlying the external reporting formats. Two questions arise here: can the system provide reliable *measurement of investments* in intangible assets and, secondly, how reliable is *impairment accounting*?

On the issue of *measuring investments* I underlined already the importance of acquisitions where a market value is attached at least to the total of acquired assets including those not recognised before. In many cases this creates an effective yardstick for valuation. Two other recent developments are of importance here.

The first development is *outsourcing*. More and more the creation of intangible assets is organised through third parties like marketing agencies, software houses, research institutes etc. etc. In fact there is a transaction taking place between the company and a specialised agency. Before deciding on the assignment the company will have asked for several bids from competing agencies to be sure the service is delivered at market price and performance will be measured against the negotiated conditions. Current practice of *outsourcing* should give rise to a thorough rethinking of the notion of 'internally generated' intangibles and consequently of the recognition criteria attached to this notion.

A second development is *activity based costing,* and similar accounting techniques that provide reliable information on the cost outlays related to certain activities including those resulting in intangible assets. I am afraid these recent developments in management accounting have insufficiently been absorbed by standard setters and others who are responsible for developing the financial accounting discipline.

As to the *reliability of impairment accounting* it is important to note that this has to do with both the strategic feasibility and operational efficiency of business activities. Through a break down into segments the group financial figures are indeed segmented according to lines of business and/or geographically. Further down there is the concept of 'cash generating unit' that is indispensable for a proper assessment of impairment. As part of the yearly budgeting and forecasting procedures 'weak areas' within the group will be spotted at the lowest level. This will be further communicated to the top, where decisions should be taken as to the impairment accounting, linking the performance figures to more strategic considerations. The internal reporting systems of large entities are certainly capable of reliable assessments as needed for continuous 'impairment accounting' as advocated before.

For obvious reasons this system will not work in an environment that is highly discriminatory between (intangible) assets acquired through acquisition on the one hand and internal investments in similar assets on the other (see the above examples of Reed Elsevier and Wolters Kluwer). After a few years the operational departments in the company will lose track as the newly acquired activities are integrated in the existing lines of business of the acquirer. As indicated already, such discrimination is an extreme weakness in the state of the art of accounting.

7 Quantification

Before concluding on the 'intangible issue' here is an attempt to quantification. Further research may reveal more of the impact of an accounting change as proposed, but at least a first approach is the following.

What we need to know is the amount of expenditure on intangible investments that is expensed today. To collect such data it would probably require thorough investigation including inside knowledge from the business community. From the outside we could at least figure out how on a company basis the gap relates to total revenue (sales). We calculated this relation for the 117 AEX listed companies in Graph 1 and the outcome is an average number of 0,8. So – on average – if yearly expenditure on intangible investments would amount to 10% of sales it would take 8 years to fill the 'gap' by capitalising intangibles instead of expensing them immediately. In fact this period will be stretched out because each year the carrying amount will be reduced by depreciation and write-offs through impairment. For the population under investigation there is a substantial variety, the 'gap/sales' relation ranging from 0 to 8,2.

8 Conclusion: should the gap be filled?

The case for resolving the 'Intangible Issue' was built up along the lines of filling the gap between book and market value. It could be argued - and in fact I did very strongly on other occasions - that there is no need to fill that gap as bookvalue is intended to serve a totally different purpose, at least not to reflect the real economic value of the firm (Bak 1994, 1995).

Taking a closer look the case is not really built on filling the gap per se, but more on transparency and consistent application of basic accounting concepts (Bak 1996). Looking at the huge and growing amounts that are kept from the balance sheet just because they are spent on intangibles, I wonder why we insist on capitalising any assets at all. To select (mainly) tangible assets for capitalisation is at least arbitrary and probably still heavily based on 19th-century concepts of economic value. Our observations on impairment accounting are also critical. The possibility of capitalised intangible assets causing losses in a later stage may be seen as an argument pro capitalisation and against it at the same time. Personally I prefer transparency over prudence! A recent example clarifies this again as the new Unilever Chairman did announce the divestment from the majority of the ca 1800 brands presently operational in the Group world-wide. A major change in strategy related to huge investments in intangible assets over the past periods. But no impact at all on the financial position as reflected in Unilever's balance sheet! (Unilever 1999).

The 'Intangible Issue' may also be seen as a cornerstone for the continuation of financial reporting in conventional terms. In recent years several proposals are being developed world-wide to cope with the problem of the declining information value of the core financial statements. Proposals are in the direction of more disclosure including non-financial information, performance indicators, and fair value accounting (Vlotman 1998). Others even suggest the end of formal financial reporting, allowing investors and other interested parties direct access to part of a companies database (AICPA 1997). Before entering into all such experimenting would it not be better to simply expand the scope of primary financial statements by dropping the irrational borderline between tangible and intangible assets?

Finally there is the accounting research argument eloquently worded by Baruch Lev and others in numerous articles, papers etc. (Lev 1998).

According to these scientists the predictive capacity of basic financial statement figures is declining over the years. They also point to the fact that traditional accounting is to slow in adapting to new economic circumstances where intangibles are taking over gradually from tangibles in determining the earning capacity of a firm.

9 IOSCO endorsement and beyond

Under this general heading we discussed today international harmonisation in the field of financial reporting. This is a unique process started up by the accounting profession back in 1973 on a full voluntary and private basis. At that time, more than today even, comparability of financial information (if any) stopped at national borders. Different economic developments and a big variety in social and legal structure had caused huge reporting differences between individual countries. Convinced that one day the world would definitely need this the accounting profession - through IASC - simply started to create standards that would be of a supranational nature. By its voluntary and private nature IAS have no authority other than their inherent quality. Five years later IFAC started its activities to create similar international standards on auditing.

During the last ten years a serious attempt is going on to have these standards endorsed by IOSCO. This is an important step in the direction of real enforcement and getting it out of the voluntary atmosphere. In preparing the core set of standards that would fulfil IOSCO's requirements the accounting treatment of intangible assets has been a major stumbling block. Hopefully the compromise solutions laid down in IAS 38 as issued September 1998 are sufficient to obtain the necessary consensus as a basis for endorsement. However, it is my personal view that the debate should be reopened in due time in order to remove irrational restrictions imposed on capitalisation of intangible assets.

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