Intangible Compliance: Capturing Overlooked Value

By Francine Trevejo-Darko, Doug Adams, Donald P. Bouchard

The New Rules

Over the last few years there has been a major shift in accounting rules that requires companies to identify and value any intangible assets they can. The aggregate value of all identified intangibles must be reported on the balance sheet along with the depreciation and the net value. The U.S. rules, Financial Accounting Standards Board (FASB) Statement 141/142, currently only apply to those intangibles acquired by acquisition but logically there is no distinction between intangibles acquired by acquisition and those developed internally. International rules, International Accounting Standards (IAS) 36/38 do not make that distinction and neither do the Securities and Exchange rule (SX) that requires all public companies to identify and value all intangibles that account for at least 5 percent of their company's total intangible value.

What Are Intangibles

Generally, these are assets that are neither physical, financial nor human. This is the definition that FASB uses and they detail these as falling into the following categories:

Business related:	Business methods and processes, know-how
Marketing related:	Trademarks, trade dress, URL's, non-competes, customer lists, relationships
Artistic related:	Pictures, photographs, advertising jingles, videos
Contract based:	Licensing, royalty, standstill, supply agreements
Technology based:	Patented and non-patented technology, software, formulae, recipes, trade secrets

In more general terms, intangible assets are those that cannot be easily seen or measured and yet contribute to the value of the organization either through being incorporated into products, being spun out as new ventures or generating licensing revenues.

Reasons For The New Rules

These new accounting rules related to intangibles are a recognition of the fundamental switch that has occurred in the last fifteen years, in which the composition of the typical company has transformed from one in which close to 70 percent of the value resides in the physical assets to one in which 70 percent of the value resides in the intangible assets. In this situation, the regulators concluded that investors (particularly those investing in public companies that generally are under the impression that they have full visibility into the financial situation of the company) actually have substantial gaps in their visibility into the company's financial situation. This applies particularly to the value residing in the intangible assets which typically are buried in either 'goodwill' or in expenses—typically 'R&D expenses.'

Various researchers have shown that R&D investment drove profitability—not the other way around (Baruch Lev, NYU, Summer 2004).* Physical and financial assets have an almost immediate impact on revenues (and hence corporate value) as they can be immediately deployed. However, intangible assets typically do not impact revenues until after two or three years. For this reason, intangible assets and their associated metrics are some of the few leading indicators of corporate economic performance.

Various regulators and standard boards have been quoted on the topic of accounting for intangibles, some of which are quoted below:

Peter Wallison (Resident Fellow, American Enterprise Institute)—"Today, substantially all of a company's profitability can depend on intangible assets, so the accounting problems associated with intangibles becomes quite serious."

■ Doug Adams, Vice-President, Technology Transfer Innovation International Americas Inc., New York, NY., U.S.A.
E-mail: dadams@innovationinternational.com

■ Donald P. Bouchard, Technology Transfer Innovation International Americas Inc., New York, NY., U.S.A.
E-mail: dbouchard@innovationinternational.com

■ Francine Trevejo-Darko, Technology Transfer Innovation International Americas Inc., New York, NY., U.S.A.

*http://www.strategy-business.com/press/16635507/04203

Arthur Levitt (former chairman, SEC)—"As intangible assets grow in size and scope, more and more people are questioning whether the true value–and the drivers of that value–are being reflected in a timely manner in publicly available disclosure."

Alan Greenspan (former chairman, Federal Reserve)—"There are going to be a lot of problems in the future as accounting is not tracking investments in knowledge assets."

Alan Cullen (Chairman of the Private Capital Council)—"Intangible management is the inevitable next essential step from knowledge management, intellectual capital."

Dr. Ken Stanfield (Chairman of the International Intangible Management Standards Institute—IIMSI)—"The 500 largest firms in the U.S. generated intangible value of $7.2 trillion (69.9 percent of total value). These firms cannot use conventional management systems to identify, classify, and report this intangible value. The only solution is to implement completely new management systems based on international intangible standards."

Review Of Levels Of Compliance

Given the significance of the new rules on accounting for intangibles and the increased focus on compliance, it would be interesting to find the extent to which companies are in compliance with the new rules on accounting for intangibles.

PriceWaterhouseCoopers conducted a detailed analysis of S&P 500 companies and determined that over 70 percent of their market value was attributed to their intangible assets (*Business Wire Online*, April 2000).

If companies were fully compliant with the rules, then we would expect that this proportion (or one relatively close to it when averaged over many companies) would be what we would find in the ratio of reported intangible assets to total assets.

In an interview on Intangible Assets and Valuation, Baruch Lev stated that the market value of S&P 500 companies is more than six times what is reported on their books. In other words, for every $6.50 of market value, only one dollar appears on the books. "It's extraordinary that the balance sheet number reflects only 15 percent or so of the value of these companies. And since this is the S&P 500, it includes about 80 percent of corporate America, a lot of financial institutions, low-tech, all the oil companies and retailers. This is not the new economy. And even if those who are right to think that this market value is inflated, if you take 50 percent off the market capitalization, there is still a huge gap." Lev noted that this flaw in firms' financial reporting mostly hurts the companies themselves: "When there are deficiencies in information, if investors don't know about intangibles, they are going to assume the worst. In capital markets, no news is bad news."

Methodology

The methodology was to take data from Reuters Knowledge Investment Management market data service on the S&P 500 relating to the value of total assets, intangibles assets and goodwill for each of the reporting years in the time period. If for any reason the information was not available then it was excluded from the study. The total asset value was then ratioed to the reported intangible value for each company.

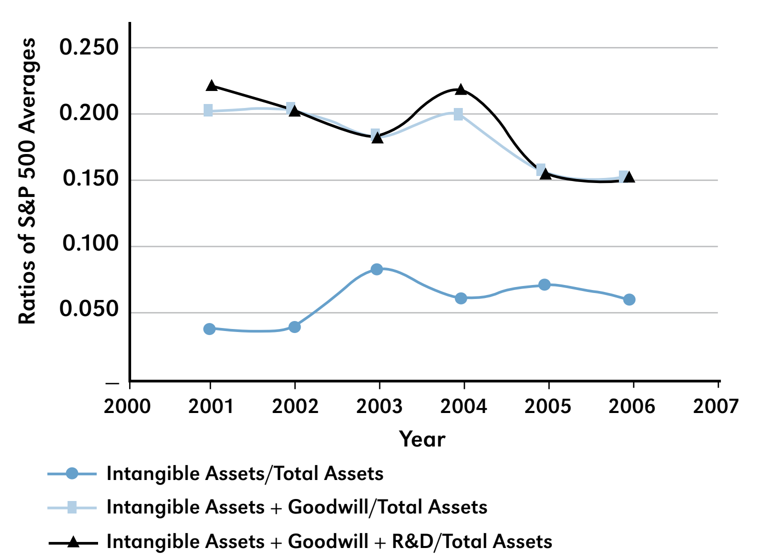
Results

Overall Compliance

What we found was very different from the ratios we would have expected based on the PriceWaterhouseCoopers research if the companies had been fully compliant. In fact for all 500 S&P companies, the average ratio of reported intangibles to total assets was close to 6 percent reflecting a non-compliance level of 91 percent!

In any other category of financial compliance, such

Figure 1: Mean Ratios Of Reported Intangible Assets To Total Assets For S&P 500 Companies From 2000 - 2006



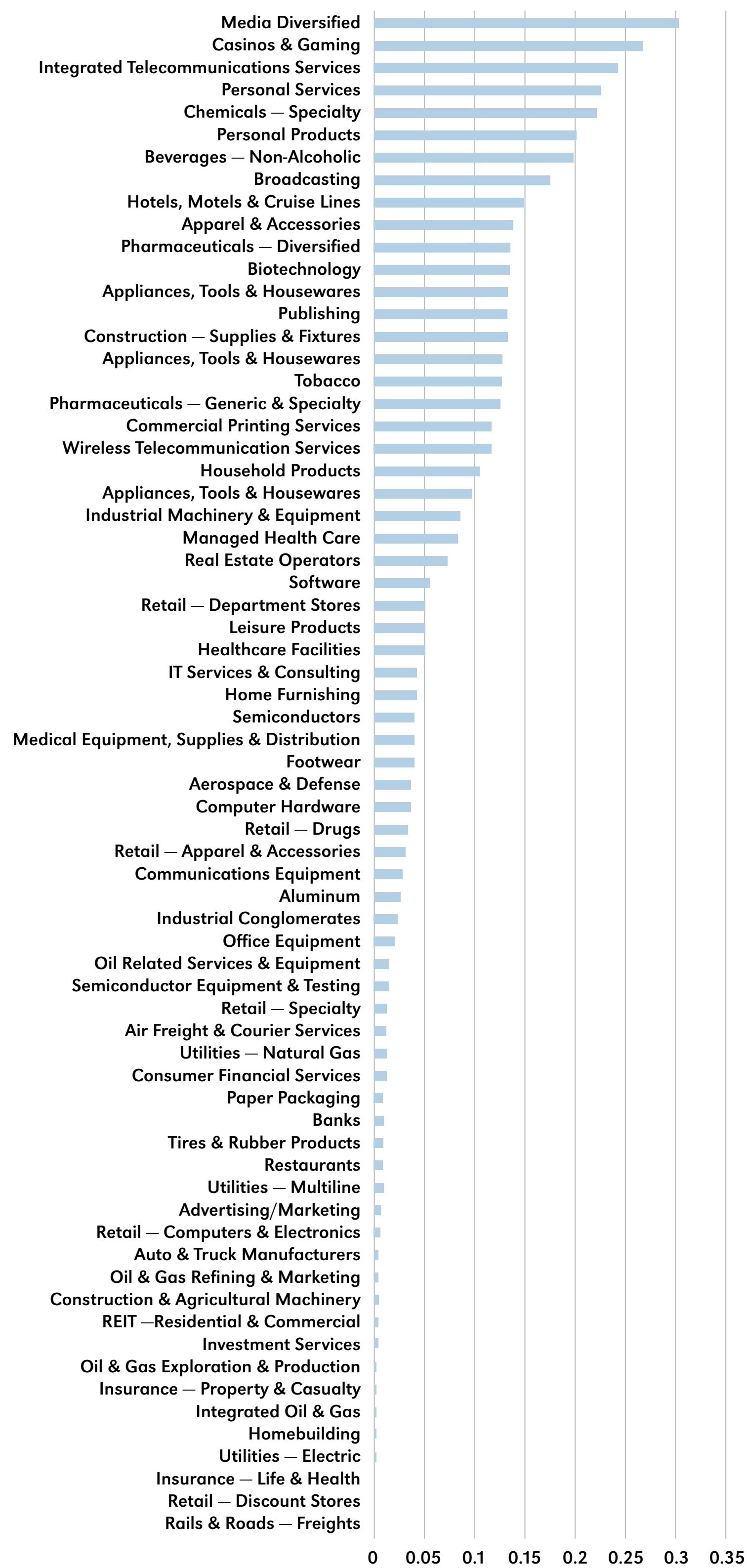
a level of non-compliance would not be tolerated and would have resulted in a flurry of non-compliance letters from the regulators.

Even more interesting is that the level of compliance has even decreased in recent years with an initial peak of compliance of 8 percent in the first full reporting year following the introduction of the regulations, then followed by a steady decline in the following years. Also as can be seen from Figure 1 there is a change in the levels of intangible assets reported with a corresponding inverse change in goodwill. We believe this reflects the fact that as companies comply with the new accounting rules, and at least partially identify and value intangibles, then a large portion of these intangibles are ones that were effectively 'buried' in goodwill. The other line item that is impacted is R&D expense. The author believes that these two items together account for most of the value in the newly identified intangibles. This has the effect of 'improving' the balance sheet for companies in that identifiable assets are much higher although it does raise some tax issues. However with the flexibility in most of the current rules on intangibles in issues such as 'useful life of the intangible asset' then the tax issues are largely favorable for the company.

Figure 2 shows the relationship between total value and intangible value by industry. It can be noted that there is a higher level of compliance (albeit still low) in those industries that are traditionally IP rich and are accustomed to attempting to track intellectual assets.

The highest ratios are with the media industry in which much of its value is in either its content that generates revenues through its copyrights, broadcast rights, or brand values associated with the masthead in the case of newspaper and magazine publishers. Also high on the list is the

Figure 2: Intangible/Total Asset Value By Industry



casino and gaming industry rich in brand names and patented software. Naturally, traditional industries such as Energy, and Rail/Road Transportation will exhibit a lower ratio of intangibles than they do on expensive infrastructure (tangible assets).

Why Is Compliance So Low

The transfer of value from Goodwill and R&D expenses to identified intangible assets would be a practice that most would imagine Chief Financial Officer's are in favor of. Given the complicated and convoluted transactions many companies got involved with during the height of the corporate accounting scandals, one would have thought they would have welcomed the opportunity to improve their balance sheets in a manner that was not only legal but was being requested by the regulators.

The reasons we believe this has not happened are threefold:

Lack of awareness of the regulations

Contrary to what one would expect given the low compliance rate, a surprising number of CFO's do seem to have a clear understanding of the new rules relating to intangible assets but many still are completely unaware of them.

The difficulty in identifying intangible assets throughout the enterprise

Intangibles, as their name suggests, tend to be rather elusive. They are not a physical inventory that can be counted like equipment, for example. Instead, they are often very abstract in nature and frequently are evolving and mutating over time.

Indeed FASB seems to recognize this problem when they state:

"Companies' inability to identify and inventory intangible assets may be the most significant obstacle to any comprehensive recognition of intangible assets. Managers cannot measure assets that they do not, today, identify and manage as assets. FASB Report April 2001.

The difficulty in valuing the intangibles

While FASB mandates that intangibles must be valued, it is 'silent' on how they should be valued (other than the indication that consistency is important under GAAP in general). Both the science and the art of valuing intangibles are in the early stages of development. The methodologies are typically basic and the costs to calculate the value are typically high.

Conclusions

The difficulty in understanding the economic impact of intangibles is of overwhelming importance to our economy and financial markets. The regulatory bodies around the world have been amongst the first to recognize this issue and have introduced what we believe to be important and appropriate regulations and guidelines.

However the level of compliance is embarrassingly low due to the acknowledged difficulty in identifying, managing and valuing these intangible assets. This is a problem that must be quickly overcome given the significance of intangibles in representing a complete financial picture of companies, and for that matter the entire world economy. ■