

# Reporting On Intangible Assets



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**A**s intangibles have become increasingly important as assets for business, so has the need for companies to manage them and report on their value to investors. But despite the best efforts of companies, regulators, and standard-setting bodies, doing so consistently and clearly has been difficult, and common standards are few.

This paper identifies some of the main issues and concerns about reporting, and highlights some of the evolving solutions. It also reviews the position of the Intellectual Asset Reporting Standards (IARS) Committee of the Licensing Executives Society (USA & Canada), Inc. on this topic.

## The Importance of Intangibles

A significant but little-noticed line was crossed by the business world a few years ago. The line separates a world where tangibles are the major source of value for corporations from a world where *intangibles* are the major source of value. This crossing didn't cause any particular stir. It wasn't mentioned in the newspapers and hasn't been covered by the television nightly news. In fact, it wasn't until long after the crossing that the business world realized that an important sea change had taken place.

For centuries the world saw tangibles as a primary source of value. Many were valuable because of their usefulness (houses, food, petroleum), while others were valuable because of their scarcity (gold, diamonds, amber). In business, a firm's value was determined, at least in part, by the number and value of the tangible assets it owned. Balance sheets were created as report cards that tallied the sum of the values of the firm's individual tangibles. The

sum of these values represented a floor or lower boundary of the value of the corporation.

In the last quarter of the 20<sup>th</sup> century, business saw an increasing interest in intangibles. In the emerging "information society," information was to have great value and would change our lives forever. Events of the 1980's and 1990's moved us toward this new reality. The introduction of the Internet and the World Wide Web, the increasing capabilities of the telecommunication and computing industries to provide customized information on demand, and the recognition that the ideas and innovations of a firm's employees create the products and services that provide investors with profits' were part of creating the environment within which intangibles such as knowledge, information, and innovation have become the fundamental sources of value in industrialized society.

With the transition into the world of intangibles, business is only now coming to understand that it faces a new set of problems with major implications both inside and outside the firm. Internally, companies are learning to manage the new intangible assets, whose characteristics differ somewhat from those of the tangible assets they had managed for so long. Balance sheets don't even list intangible assets; much less indicate their value. Indeed, the rise of intangibles as a major source of value for corporations has created issues not foreseen by regulators or by the capital markets.

If intangibles are a major source of value for corporations, then it is logical to suspect that they must somehow underlie the company's total value (i.e., its market capitalization).

But what is the relationship between intangibles and corporate value? Sadly, a deterministic relationship between the two still exceeds our grasp. Nevertheless, on a subjective level, many employees know intuitively that their firm's intangibles have value. They *know*, for example, without any dollar-measured proof, that knowledge, ideas, and innovations are the sources of the products and services that generate their company's revenue. They *know* there is latent (unused) value in their company's knowledge, ideas, and innovations. They *know* that much of the value investors see in their company is based on those investors' perceptions of the value of the firm's intangibles. And finally, they *know* that if only investors were more fully informed about the value (current and potential) of the company's intangibles . . . the firm's stock price would rise!

How can current and potential investors obtain more and better information about a company's intangibles and their value to the firm? The answer lies in part with what the company tells the investor community about the firm's intangibles. What and how a firm should report about the use and value of its intangibles as well their potential impact on future earnings is a subject of considerable debate in regulatory, accounting, financial, and economic circles.

Regulators are concerned with the "level playing field issue." This is the concern that major investors have

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more access to information about a firm's intangibles than do small investors, whose access to the time, energy, and insight of major corporate officers is limited or nonexistent. Of equal if not greater importance is access to accurate information of all kinds relating to intangibles. In large measure, it is the lack of accurate information that underlies most if not all of the market's concerns about intangibles.

### A Brief History of Reporting on Intangibles

In the mid-1990's, Commissioner Steve Wallman of the U. S. Securities and Exchange Commission (SEC) initiated several symposia on accounting and intangibles whose theme was revolutionary at the time: that the accounting for intangibles was falling far behind their use in corporate America and that companies increasingly were deploying intangible assets to drive wealth production. Moreover, sorely in need of review was the premise that financial statements, including traditional financial reporting and disclosure, were providing investors the information needed to make informed investment decisions. At least that assumption needed to be questioned. The answer, to those who wished to look, was that traditional financial reporting was not doing its job and that significant changes were needed.

At a series of informal conferences, interested people were asked to opine on whether, and to what degree, the lack of information about intangibles was a problem for investors. The consensus view was that there was a problem and that its solution would perforce be complex. Nevertheless, Mr. Wallman persisted, and at the end of his term with the SEC he enlisted the aid of the Brookings Institution to sponsor an open committee for the purpose of creating shared definitions of intangibles that companies could use to report about, should they wish. Even this well-intentioned effort failed. It seemed that the task of agreeing on the categories of intangibles was more difficult than expected.

Meanwhile, in other parts of the industrialized world, businesses and governments were dealing with these same issues. In Europe, the Organization for European Cooperation Development (OECD) has been investigating the reporting of intangibles for several years. In the Scandinavian countries, where companies have reported on intangibles since the early 1990's, an organization called Nordisk Industriond promotes the importance of reporting on intellectual capital, helps companies to develop their own reports on intangibles, and works with companies to integrate reporting on intangibles into corporate practice.

The Canadian Institute for Chartered Accountants, concerned that with the increasing importance of intangibles, accounting (a method devised to "account for" tangibles) could be seen as obsolete, has been developing a system for measuring intangibles to complement accounting, not to replace it. Their efforts are focused on providing new tools for measuring and auditing a firm's in-

intangibles in a variety of ways, not all of them currency-based.

In the United States, the Federal Accounting Standards Board has issued two new rulings on how firms are to account for purchased intangibles, or for those that were acquired as part of a merger or acquisition. These rulings call for firms to list the intangibles along with their purchase price (i.e., their market value).

### How Tangibles and Intangibles Differ

Only recently has the management community become aware of the differences between tangibles and intangibles. This may be because companies have only recently attempted to manage their intangibles and, in so doing have learned that they neither act like tangibles nor respond to management in the ways that tangibles do. The following is a brief summary of some of the key characteristics of these two forms of assets:

As the foregoing demonstrates, intangibles are much more complex

	Tangibles	Intangibles
<b>Rivalry</b>	Deployment for one use precludes other.	May be deployed simultaneously for many uses.
<b>Excludability</b>	Benefits may be enjoyed by the owner exclusively.	Both owners and non-owners may benefit from their use; excludability is difficult.
<b>Markets</b>	Markets exist; market value is relatively easy to determine.	Markets either do not exist or are thin; market value is difficult to determine unambiguously.
<b>Value</b>	Fair market value (FMV) is a good measure of value to the owner.	FMV is usually different from value to owner; FMV may be determinable for only one use, but one intangible may have more than one use; value-in-use (VIU) may be a more accurate measure of value to the owner.

Source: Adapted from B. Lev, *Intangibles* (Washington, D.C.: Brookings Institution Press, 2001), Chapter 2.

assets than tangibles. When it comes to extracting value, intangibles can be particularly complex, leading to as-yet-unresolved issues in reporting on their value. Their ability to contribute to multiple value streams simultaneously, for example, makes determining (and reporting on) their value more difficult than is the case with tangible assets.

### **Fair Market Value vs. Value-In-Use**

One basic issue that must be agreed on is the *form* of value to be reported. Current accounting practice requires that assets be reported at cost or market value, whichever is lower. Market value, also called fair market value (FMV), is the form of value with which most business people are familiar.

The value of the asset to its owner is not significantly different from its value in the marketplace. That is to say that the value of a building is likely the same to its owner as it is to potential purchasers. The same is largely true for a machine, a desk, or a corporate bond. But this is specifically *not true* for an intangible asset.

The value of an intangible depends on its context. An idea that is considered to be very valuable by Coca-Cola might not be deemed valuable at all by Pepsi-Cola. In other words, two companies, in the same industry, may value an intangible asset quite differently. The reason, of course, is that the two companies operate in different contexts: they have different assets, different business strategies, different personalities among the management team, different manufacturing facilities, different distribution networks, and different product mixes. An idea in one context has a different value than it does in the other.

While FMV tells us what parties *other than the owner* (i.e., the “marketplace”) would pay for the item, this may not be the measure of value that is of most interest. What is often of greater interest is the value of an intangible to its *owner*. This value, the value-in-use (VIU), is determined by knowing how the owner

expects to use the idea. So, for example, suppose Coca-Cola has an idea about a new way to vend its cola products, say in a new form of soda fountain. If Coca-Cola’s business plan includes generating revenues from vending as well as from the sale of Coca-Cola syrup, then this idea may be very valuable. If, however, Pepsi-Cola has no plans to incorporate vending income into its revenue mix, that company would find the idea of little value.

If current or potential investors in Coke wanted to know about the value of the company’s intangibles (e.g., its ideas), they would be interested in their value-in-use. The fair market value of the tangibles would be of little interest, because investors want to know the revenue potential (i.e., the VIU), not the sale price of the intangibles.

Reporting on the FMV of a firm’s intangibles may actually produce a value that is lower than the VIU. Further, if the FMV does not reflect the value to the corporation, it is likely to be an inaccurate measure of value. Perhaps of even greater concern, to an unsophisticated investor, this incorrect FMV will have every appearance of being correct, and thereby be particularly misleading.

### **Reporting on Intangibles: A Spectrum of Possibilities**

There is a spectrum of alternatives for the reporting of intangibles. Below are some possibilities for consideration.

1. *Listing the company’s intangibles.* This is perhaps the simplest of the possible reporting possibilities. Using this approach, companies would identify and list their significant intangible assets either individually or in logical groupings. What should be included in a list of intangibles is not clear-cut. Some items are obvious and uncontroversial, such as a company’s patents, trademarks, and other intellectual property. Less obvious is whether to include in-licenses, contracts, nondisclosure

agreements, customer relationships, knowhow, and organizational capabilities.

2. *Subjective valuation of the company’s intangibles.* This is the next logical step in reporting on intangibles. For each listed item, the company would write a paragraph or two describing how the intangible is used (or will be used) and how its use contributes to the company’s vision, business strategy, or some other standard for measuring value to the company. Under this heading, an intangible could be identified as contributing to several value streams simultaneously.
3. *Quantitative valuation of the company’s intangibles.* This is the area surrounded by the most controversy. At one level the controversy is whether to include the value of intellectual assets in the company financial statement. At another level, the controversy is whether it is possible to value intangibles unambiguously. And at still another level, there is controversy about whether and in what circumstances it is appropriate to use FMV or VIU, and what methods should be used to calculate value.

In addition, there is further pressure (both political and market-related) in the wake of the accounting and financial scandals currently roiling Wall Street. Standardsetting bodies as well as government regulators are searching for practical methods for understanding and reporting on the intangible assets of the firm. In view of these pressures, reporting on intangibles is likely to be mandated.

### **LES and the Reporting of Intangibles**

The members of the Licensing Executives Society, by virtue of their interest in licensing, are all involved in some fashion with intangibles. Any movement toward reporting on intangibles is likely to affect many or most of the members of

the society. With this in mind, LES (USA & Canada) has established its Intellectual Asset Reporting Standards (IARS) Committee to monitor developments in this area as well as to consider whether LES (USA & Canada) should make any recommendations on reporting and, if so, to whom.

In a recent interview, Russ Barron, founding chairman of the IARS Committee, described the committee's first-year activities as productive and said that its focus "has been to learn about the field and to begin sorting out the best role we can play for the benefit of the membership of LES."

The committee reviewed a number of reporting methods and approaches employed by member companies as well as several research efforts in the field. The committee even attempted to develop a draft reporting standard in order to learn what difficulties were involved with this process. At the end of its first year, Barron reported that the committee understands the complexities of intellectual asset (IA) reporting and further understands that other research and implementation efforts are already under way throughout the industrialized world. "It isn't yet clear," said Barron, "which of the several approaches being tested around the world will work best. Nor is it yet clear where we might make our own contribution to the benefit of the society or to the field of IA reporting. It is clear that we have made a good start and we have a lot more work to do."

The committee has identified three areas of emphasis for its continuing activities:

1. Monitor developments by communicating with:
  - a. bodies concerned with IA reporting;
  - b. bodies developing IA reporting methods or suggesting standards;
  - c. individuals involved with IA reporting and standards development.

2. Keep members apprised of intellectual asset reporting developments (and their implications).
3. Continue to develop a definition of the role LES (USA & Canada) wishes to play in the intellectual asset reporting arena.

### Summary

For many companies the value of their intangibles far exceeds that of their tangibles. Principally for this reason, it has become important for firms to manage this new form of asset. In addition, the current market environment has increased the momentum to provide investors and other interested parties with information about the number, kind, and use of these intangibles. But because most of the management methods in use were developed for the management of tangibles, they do not deal with intangibles equally well. This is primarily because the characteristics of intangibles and tangibles differ markedly. For example, while it is easy for the owner of a tangible asset to reap its benefits, the owner of an intangible asset may have to share its benefits with others. Other differing characteristics include rivalry, marketability, and form of value (FMV vs. VIU).

The challenges associated with managing intangibles are matched by the challenges associated with reporting them. Companies will want to consider the full spectrum of reporting possibilities, to decide which reporting method meets the needs of regulators, shareholders, employees, and other stakeholders.