Get ready for management commentary

It may not be worth putting intangibles on a balance sheet, but including them in management commentaries is a completely different matter

By **Rob McLean** and **Patrick H Sullivan**

For years, the intangibles community has been fixated on the fact that only a small subset of intangibles are on the balance sheet. Business people ask: why can't I put all my intangibles on the balance sheet? And they are told by CFOs that doing so violates Generally Accepted Accounting Principles (GAAP). Some critics claim that the failure to recognise all intangibles as assets is a sign that accounting has lost its relevance or is in crisis.

As disappointing as this may be to some companies and to the critics, we conclude that the way intangibles are treated in financial statements is unlikely to change substantially.

Crucially, however, we argue that continued debate about intangibles on the balance sheet is old hat and not worth the bother. This is true even for companies whose assets are largely intangible: even if they could treat intangibles as balance-sheet assets, these would be measured at cost, not at their true value.

In our view, the focus should shift away from financial statements alone to a broader perspective on disclosure that includes management discussion and analysis (or MD&A as it is referred to in North America) or management commentary (MC, which is the more generic term being adopted globally). The important question for the future is not: "why can't I put my intangibles on the balance sheet?"; but "how should I disclose my intangibles?"

Unlike financial reporting, the standards for MC are embryonic. While financial statements are principally comprised of cost-based measures reflecting past transactions, the intention is that MC should include value-based measures reflecting future events. Many expect that the International Accounting Standards Board (IASB) will embark within the next year on a formal process aimed at developing international MC standards.

As that process unfolds, the intellectual assets community should be getting ready for new controversies that could dwarf the previous debates about intangibles on the balance sheet. If the focus of MC includes disclosing something about value, intangibles professionals know that this begs questions such as: value in what context? From which perspective? In accordance with what measurement approach or standard? The evidence so far is that the people writing the standards for value disclosure are still living in the tangibles paradigm.

This raises important issues for the IA community: not least whether we need to become an active participant in the standards processes for intangibles valuation and disclosure.

Intangibles on the balance sheet

Many criticisms have been made about how accounting deals with intangibles. Some claim that accounting has become out of touch with the rise of the so-called knowledge-based economy. Many have pointed to an increasing gap between enterprise book value and market value as evidence that intangibles have more and more hidden value that is missing from financial statements.

These criticisms reflect a profound misunderstanding about financial statements and how accounting works. Before we can get to the important issues of the future, we need to set the record straight on four fundamental points. Let's deal with each of these in turn.

Accounting for intangibles transactions

Accounting records intangibles just like tangibles: based on transactions.

When a company buys a machine, it records the cost of the machine on the balance sheet. Subsequently, the company annually charges a portion of the original cost (referred to as depreciation expense) against income. The idea is to allocate the total cost of the machine against the income it helps to produce over the machine's economic lifetime. By contrast, when a company buys a piece of land, it does not record depreciation expense because land does not have a finite useful life.

The accounting treatment of intangibles is exactly parallel to the accounting treatment of tangibles described above. When Company A buys a patent portfolio from Company B for US$10 million, this transaction is recorded on the Company A's balance sheet at the cost of acquisition. This cost is then allocated against future income by recording amortisation expense (equivalent to depreciation) over the economic life of the patents. On the other hand, goodwill, like land, is not amortised because it is considered to have an indefinite useful life.

Accounting for self-generated assets

The big difference in the accounting treatment of tangibles versus intangibles arises with respect to self-generated assets. If a company builds a machine instead of purchasing it, the machine is recognised as a balance-sheet asset. However, if a company creates intangible assets by developing a patent portfolio, this will not be recognised. The difference is important because in most companies, the vast majority of intangibles are self-generated.

So what is the justification for this difference? It arises not because of the accounting definition of an asset – traditionally, assets are "economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained". Both tangibles and intangibles fit this definition. The difference arises because of what are called in accounting recognition criteria. One of the key recognition criteria is that an "item has an appropriate basis of measurement and a reasonable estimate can be made of the amount involved".

Self-generated intangibles are excluded from the balance sheet because it is too difficult to measure them accurately. At first glance, this appears to be a flimsy excuse: surely it can't be that hard to tot up the costs of filing a patent. On a closer look, the issues are not so clear-cut. Let's assume a company spends US$1 million filing 10 patents in 2006, but only five are granted. Should the cost attributed to the granted patents be US$100,000 each (on the assumption that the total US$1 million cost is allocated equally to each filed patent), or US$200,000 each (on the assumption that unsuccessful filings are a normal part of the cost of successful filings)?

While measuring self-generated intangibles does raise some complex issues, accountants would have solved them by now if there were a real interest on the part of companies in implementing new cost accounting systems for intangibles, similar to those that exist for manufacturing operations. So far, companies have evidently concluded that it is not worthwhile to track the costs of generating intangibles at such a granular level. As a result, accountants lack the measurement information necessary for intangibles to meet the asset recognition criteria.

Intangibles in M&A transactions

The rules for intangibles in M&A transactions were changed a few years back by both US and international standard-setters. While these changes have generated a lot of activity for accountants, in the grander scheme of things, all we did was move some intangibles out of the bucket we call goodwill into their own unique bucket.

Accounting for intangibles – the reality

Criticisms about how accounting deals with intangible assets reveals a lack of understanding of the principles that underlie financial reporting. Critics need to bear in mind four fundamental points:

- Accounting deals with intangibles in exactly the same manner as tangibles, based on transactions with third parties.
- The only important difference between how accounting deals with tangibles and intangibles relates to assets that are not acquired from third parties, but are generated internally. Self-generated intangibles are excluded from balance sheets because of accounting's asset recognition criteria.
- While the changes introduced a few years ago for intangibles in merger and acquisition (M&A) transactions have generated a whole lot of activity among accountants, they didn't change the *status quo* with respect to the two points above. It merely moved some intangibles out of the goodwill bucket into their own unique bucket.
- Even if self-generated intangibles were recognised as assets, this wouldn't close the so-called gap between enterprise book and market value. Financial statements are about historical cost, not market value. The so-called gap was initially a great metaphor, but has no continuing relevance.

Let's illustrate this by a simple example. Assume Company A has bought control of Company B for US$100 million. Accounting standards require that when Company A publishes its financial statements, Company B's accounts must be combined, or consolidated with the accounts of Company A. Let's assume that the net book value of Company B's assets is US$60 million. On consolidation, Company A needs to find a way to report on the difference between what it paid for Company B (US$100 million) and the net book value of Company B's assets (US$60 million). Accountants had to invent a term to describe this difference, and instead of calling it the excess of the purchase price over the net book value of assets acquired (which is what is actually is), historically they called it goodwill.

A few years back, accounting standard setters concluded that it would be more meaningful if we carved out of this so-called goodwill the value of identifiable assets that were unrecorded in the books of Company B, such as its self-generated intangibles. If Company B's self-generated intangibles consisted of a patent portfolio estimated at US$10 million, then this amount will be moved out of the goodwill bucket to the intellectual property bucket in Company A's consolidated financial statements.

Does this not contradict what we said earlier about excluding self-generated intangibles and only recording acquired intangibles? No, because we're talking about Company A. In this case, Company A indirectly acquired US$10 million of intangibles when it bought Company B. In an attempt to make the accounting treatment similar for both directly and indirectly acquired intangibles, accounting standards require a complex purchase price allocation exercise to be performed to isolate the value of acquired intangibles from the goodwill.

But Company B's self-generated intangibles will still not be recorded in Company B's books. And future self-generated intangibles for both Company A and Company B will still be excluded. Unless businesses all over the world decide to adopt comprehensive cost accounting for intangibles, this is not going to change anytime soon.

What if self-generated intangibles were on balance sheets?

The idea of a gap between book and market value is based on a fundamental misunderstanding of accounting and financial statements. Financial accounting is about tracking costs based on transactions. The objective of accounting and financial statements never was, and never will be, to explain the market value of the enterprise.

This confusion may have arisen because there is an accounting principle that requires that assets be portrayed on balance sheets at the lower of cost or market value. While all assets are originally recorded at historical cost, if the market value of an asset is below historical cost, the asset is written down to the lower value. This applies to both tangibles and intangibles. On the other hand, the reverse does not occur: assets are not generally written up to market value except in very rare circumstances.

If self-generated intangibles were included in financial statements, they too would be recorded at the lower of cost or market value. But simply adding in the cost of self-generated intangibles would not close the so-called gap with enterprise market value.

How did this notion of a gap arise? In the early days of the intellectual capital (IC) movement, Leif Edvinsson and Hubert Saint Onge, who both worked in financial institutions at the time, were looking for a way to convince senior management about the importance of intangibles. Aware of the work of Peter Drucker and John Kenneth Galbraith, they adopted the term intellectual capital, knowing it would appeal to executives working in institutions that worship financial capital. To help these executives envision its value, they suggested that IC could explain the difference between the market value of the enterprise and the book value of its tangible assets.

As metaphor, this was a brilliant idea, and caught on.

But technically, this notion is just plain wrong. Every measurement relates to some object, or more specifically, properties of some object. If you want to compare two measures, you need to ensure that they relate to the same or a compatible measurement object: otherwise the classic apples and oranges problem arises. The market value of an enterprise is a function of transactions between buyers and sellers of securities in the marketplace. The book value of a firm's assets is a function of transactions between the enterprise and the third parties from which it acquired those assets. While in both cases, the unit of measure is expressed in currency terms and related to transactions, the underlying measurement objects are completely different.

Professor Philip M'Pherson of the City University in London is a former systems engineer who became fascinated with the measurement of intellectual capital. As an expert on measurement, he gives a technical name to the apples and oranges issue: incommensurability. Values that cannot validly be added or subtracted because they relate to different objects, such as the market value of a firm's securities and the book value of its assets, are incommensurable.

While capital market participants consult financial statements in making investment decisions, there is no direct connection between assets or income and the market value of a firm's securities. Talking about an increasing gap between the market value of a firm's securities and the book value of its assets is a non sequitur, and makes no more sense than if we were to observe that there is an increasing gap between our respective heights (in feet) and our ages.

Intangibles on the balance sheet? Not worth the bother

The debate about intangibles on the balance sheet has outlived its usefulness. The accounting treatment of intangibles is unlikely to change for the foreseeable future (even though accountants are presently rethinking the definition of an asset and other conceptual foundations of accounting).

But even if it did change and the costs of self-generated intangibles were included on the balance sheet, this would not address what is a far more important question: what is the value of a company's intangibles, or the contribution of those intangibles to value creation for the enterprise and its stakeholders? As we all know, value has no necessary relationship to historical cost.

In the April/May 2007 issue of *IAM* we wrote an article entitled "The confusing task of measuring intangible value" (issue 23, pages 54-59). We suggested that the value of intangibles is measured in a business context for two overarching purposes: for disclosure; or in support of business decisions.

If the problem we are trying to solve is to support business decisions, then whether intangibles are on the balance sheet is completely irrelevant. What matters is choosing measurement approaches that are optimal for providing the needed insights. Among the key variables are: whether the measurement focus is cost or value; defining the context within which value will be measured; and other factors as discussed in the above-mentioned article.

On the other hand, if the problem we are trying to solve is to put more information in the hands of investors or other external stakeholders – that is, disclosure – then we need to consider the vehicles that are available for doing that. Traditional financial statements are not the only game in town.

The future challenge: disclosing intangibles

Looking beyond financial statements, if a business wishes to communicate with outside stakeholders about its intangibles, there are effectively two choices.

In Europe, and more recently Japan and Australia, there has been considerable experimentation with IC Statements as a vehicle for disclosing intellectual capital or intangibles. As fruitful as this has been for some businesses, the IC Statements approach is seen by capital markets regulators as disconnected from the mainstream of corporate reporting.

The second option is MD&A or MC. Attitudes to MC disclosures vary widely: some businesses provide the minimum disclosure that may be required by local capital markets regulators, believing that going beyond the minimum requirements

Key differences between financial statements and MC

	Financial statements	Management commentary
Format	• Highly structured quantitative measures	• Combination of narrative and quantitative measures
Principal focus	• Summarising financial position and results based on transactions with third parties	• Explaining past performance, and communicating strategy and value drivers affecting future performance
Timeframe	• Past and present	• Past, present and future

might expose the firm to shareholder litigation. This is particularly a concern in the United States, where the national sport is litigation and Sarbanes-Oxley has created such a huge compliance burden. Other businesses try to go beyond the minimum requirements.

One of the challenges for companies is that while there are local regulations in many jurisdictions that specify required disclosures in MC, there are few countries that provide general guidelines (with the notable exception of Canada), and no generally accepted international standards. This may be about to change: in late 2005, the IASB published a Discussion Paper on MC, and is expected to start a project soon leading to an exposure draft of an international standard for MC disclosures.

The IASB Discussion Paper (see end of article for reference) defines MC as: "Information that accompanies financial statements as part of an entity's financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements. It also explains the main trends and factors that are likely to affect the entity's future development, performance and position."

MC has the potential to provide a framework that would enable intangibles-rich businesses to describe their intangibles portfolio, its strategic and financial value to the business, and its impact on the ability of the enterprise to create value in both the short and longer run.

Whether in reality MC will provide such a framework that enables this depends on the outcome of the MC standards process: and therein lies the rub.

Disclosing value for intangibles: the coming controversies

Intangibles professionals know that any reference to value for intangibles begs a whole series of questions. There are three fundamental concepts that are critical to measuring value for intangibles: the distinction between tradable and non-tradable intangibles; the fact that value for tradable intangibles is context-dependent; and the fact that some tradable intangibles have the ability to generate multiple simultaneous value streams.

Tradable intangibles, such as intellectual property, can be separated from the organisation and valued and monetised independently. Non-tradable intangibles, such as the company's culture, cannot be separated from the organisation.

Value for tradable intangibles is context dependent. For instance, a patent may have an entirely different value for its owner than for a potential buyer of that patent, depending on each company's strategy and complementary business assets.

Some tradable intangibles, including most intellectual property assets, have the ability to generate multiple value streams simultaneously. A patent can be used to protect a company's existing revenue streams in one application or market segment, while simultaneously generating third-party licensing revenue in other applications or segments.

These distinguishing characteristics of intangibles are well known to leading intangibles professionals and specialist intangibles valuation experts, but appear to be missing from recent attempts by appraisers and accountants to define valuation standards for intangibles.

In late 2005, the American Society of Appraisers (ASA) published draft standards on Intangible Asset Valuation and Intellectual Property Valuation (see end of article for reference). The draft standards reference the traditional valuation methods that have emerged with respect to tangible assets (ie, the market, cost and income valuation methods), but make no mention of the unique characteristics of intangibles that are crucial to assessing value.

A few years ago, a group of individuals established the International Valuation Standards Committee (IVSC, at http://ivsc.org), which has been working to position itself as an authoritative international standards body, issuing its own exposure drafts. In 2006, it set up a team to develop a standard for valuation of intangible assets. While the team's work is apparently not yet public, it is evidently building on the ASA work referred to above.

The IASB and the US Financial Accounting Standards Board (FASB) have been collaborating in a process designed to promote greater harmonisation of international standards. Emerging from this collaboration are discussion papers published in late 2006 that are intended to lead towards new standards on fair value measurement. However, the emerging definition of fair value does not appear to be sensitive to the context-dependent nature of intangibles value.

In June 2007, the American Institute of Certified Public Accountants (AICPA) issued its first ever Statement on Valuation Services dealing with "Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset". While the full text of the statement is not yet available, presentation materials published at http://www.aicpa.org/bvstandard make no reference to the unique characteristics of intangibles.

Given this accumulating evidence, there is a risk that if the standards processes for MC and intangibles valuation are left entirely to the accounting and valuation professions, the resulting standards will be largely based on tangibles-centric concepts and approaches. Investors and other stakeholders will be no further ahead if the application of new MC and valuation standards results in value measurement for intangibles that are misleading and fundamentally flawed.

Unproductive debate

In sum, we argue that investing more energy in debating whether all intangibles should be on the balance sheet is not productive. The limitations of accounting with respect to intangibles are a direct consequence of accounting's reliance on measuring transactions. This is the source of its perceived reliability (because past transactions are objective facts that can be measured), but also the source of its greatest weakness. Inherently, accounting does not measure non-transactions. And in business, there are plenty of non-transactions that are crucially important: not least the business processes that create most intangibles.

While in the long run there might emerge a new accounting paradigm that is not based principally on transactions, in the foreseeable future, the IA community should shift its focus to disclosing intangibles through MC. It is highly probable that new international standards for MC will emerge in the next few years and that such standards will require broader disclosures of intangibles, which will inevitably include some form of value measurement.

Based on current trajectories, we are not yet confident that new MC standards for intangibles will reflect the unique characteristics of intangibles that in our view must be built into the way we measure value for intangibles. In the past, the IA community has not mobilised itself in a coordinated way to influence standards activities of other professions. If the concerns expressed in this article are well-founded, however, and are shared within the IA community, then we will need to insert ourselves collectively in the forthcoming processes that will determine the content, form and guidelines for the management commentary of the future, and the standards relating to valuation of intangibles. ■

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The IASB discussion paper mentioned in this article can be found at (http://www.iasb.org/Current+Projects/IASB+Projects/Management+Commentary)

The American Society of Appraisers draft standards mentioned in this article can be found at http://www.bvappraisers.org/ASA-BVexposure_files/IAS.pdf)