

Improving Financial Reporting (IFR)

Valuing Intangible Assets: How Important Is It and How We Might Accelerate It

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Panel Introduction (Jim Gregory)

The brand is an intangible, which in accordance with GAAP (Generally Accepted Accounting Principles) cannot be placed on the balance sheet unless it has been bought or sold. Therefore, internally grown intangible assets are represented as having no value. This is a problem for marketers seeking budgets to grow these assets. The marketers are trying to grow the value of the brand, but the CFO sees no value being created because the brand is not on the balance sheet. Thus, a dilemma for marketers, but equally important it is a significant obstacle to corporate growth.

Any attempted discussion of putting brand on the balance sheet makes the finance folks a little queasy when the subject is raised. One organization that is willing to discuss it openly is the Marketing Accountability Standards Board (MASB).

About this time last year Bob Lutz, from the finance group at Microsoft and representing IIRC made a presentation to MASB. The integrated reporting group he works with showed that intangible assets are growing over time. In 1975 intangible assets represented under 20% of total enterprise value. Today intangible assets represent well over 80% of the value of the company. It is also been demonstrated that brands make up a significant portion of that 80+%.

Research and brand valuation experts have come up with different ways of measuring and valuing brands. The results are widely disparate valuations – for example one firm values Apple's brand at \$40 billion and another values it at \$140 billion. It is hard to have a conversation with finance when the valuation vendors can't come up with similar numbers for the same company. But in the defense of brand valuation – there are no guidelines provided by standard setters, resulting in each vendor creating their own standards of measurement and reporting. It doesn't mean one is right and another is wrong – it does indicate the need for standards to measure and report brand value.

MASB has taken this issue head-on with two projects underway - Brand Investment & Valuation Standards (BIV) and Improving Financial Reporting (IFR) – as well as the conducting of standard audits including the validation characteristics of metrics employed by measurement firms. CoreBrand provides leadership for the IFR Project Team and was one of the first to participate in the validation audit program.

Does brand add value or not? If so (which is a point that is hard to argue), then how should it be communicated? Certainly the value of brands needs to be considered by finance and they need to be an important part of the discussion. If putting the brand on the balance sheet still makes finance queasy then perhaps there are other ways to talk about the value.

MASB's IFR Team strategy has been to partner with the financial reporting and investment communities and we have been making every effort to explain our point of view and to provide potential solutions. For example Michael Moore, Professor, Loyola Marymount University (Co-Lead of the IFR Team) and I have recently co-authored a new paper that was published in the October 2013 issue of, *The Journal of Financial Transformation*. The article is entitled, "Aligning Marketing and Finance with Acceptable Standards for Evaluating Brands." The thesis put forward in the article -- it is possible to describe the value of the brand in the MD&A notes of an annual report. The publication described the article as a "High level debate".

MASB is an organization that reaches out to academics and practitioners as well as to both finance and marketing to engage them in thinking through the potential standards relating to brand value. Recent MASB meetings have included speakers from these pivotal organizations: Financial Accounting Standards Board (FASB), ISO10668, CFA Institute, IFRS, Microsoft, IIRC, Morningstar, among others.

As members of MASB we sometimes lose sight of all the progress we've actually made in opening the dialogue with finance and the standard setters about the value of brands and the

need for standards of accountability for marketing. We have come a long, long way and we should be very proud at how much we've accomplished as a team.

We still have a way to go and still need to continue to engage finance and the standard setters in this discussion, which brings us to today's panel, which has been organized and will be led by Esther Mills.

Esther Mills is a CPA, she's the founder of Accounting Policy Plus, and her firm provides advice to corporations on complex accounting issues. Prior to opening her own firm, she was managing director at Morgan Stanley in charge of accounting policy. She also held similar positions at Merrill Lynch and Goldman Sachs.

The Panel (Esther Mills)

The panel was formed to look at this issue from the perspective of the analyst community, investor community, the standard-setter's point of view, as well as the academic side. The panelists included:

Esther Mills, President, Accounting Policy Plus, accounting consultant
Jennifer Hillenmeyer, Practice Fellow, Financial Accounting Standards Board (FASB)
Michael Moore, Professor, Loyola Marymount University
Sandra Peters, Head, Financial Reporting Policy Group, CFA Institute
Kunal Khara, Director, Financial Markets Advisory Group, BlackRock
Justin Nash, Vice President, Financial Markets Advisory Group, BlackRock

The representatives from FASB and BlackRock noted that the views expressed during the panel represented their own, and not necessarily those of the institution with whom they were affiliated.

Following is a summary of key points that were made:

Investors want more information on intangible assets

Generally, Sandy Peters advocated strongly for the valuation of intangible assets on the balance sheet, given the dearth of information available today, and the increasing need for information on intangibles in the information economy. She referenced the views of Bob Bayless, former chief accountant of the SEC in the early 2000s, about the importance of greater disclosure regarding internally generated intangible assets to value investors.¹

The BlackRock representatives also expressed a need for greater information regarding intangibles, noting that Google, for example, has a relatively small amount on its balance sheet representing intangible assets (only about 6% of total assets), which is vastly disproportionate to its market value. BlackRock believes this demonstrates that Google's balance sheet does not reflect how the market values the company, which is based in large part on internally-developed intangible assets that are not recognized in its balance sheet.

Investors want more disclosures about underlying valuation assumptions

Sandy Peters also noted that the CFA institute sometimes gets pushback for its support of more information on the fair value of assets, but what they really want is better disclosures around assumptions and techniques that underlie fair value, as well as better information on cash flows that are generated by intangible assets. This is because, while analysts may differ on the absolute valuation of intangible assets, the only way to understand these differences is to have access to the assumptions that underlie the valuation models.

The BlackRock representatives also indicated their desire for more transparency in data underlying intangible assets: specifically, what are the key characteristics of an intangible asset, and information on how the asset is going to generate revenue or incur costs over its life.

¹ See a copy of the SEC's speech at <https://www.sec.gov/news/speech/spch464.htm>

Similar to the views expressed by CFA Institute, they noted that even if they make modeling assumptions down the line that are different from that of another valuation firm, by having access to the underlying assumptions, they can still understand why and how the valuations differ.

For example, with respect to Google, they would want to know how many patents are associated with that intellectual property; what industries and sectors and technologies those patents are associated with; what are the costs of the research and development that results in those patents; and what are the costs to maintain them. They would also want to know how the patents derive revenue for the company: through licensing, or through capturing certain markets, or by bringing litigation against infringers; and finally, they would be interested in seeing how the revenues from those patents change over time as they mature and then eventually expire.

One analogy they cited was that of the development of the models used to value mortgages several decades ago. Over the last 20-30 years, as markets for this asset class developed in the US and abroad, so too did the “language” regarding how to value mortgages also develop, so that now market participants can speak to each other and understand what are the key data items that are needed to value and understand the risk of a portfolio, and how those inputs affect the models and the outputs of the models. Thus, even if market participants disagree on a particular assumption or how something works, they can still talk to one other and form an opinion about the ultimate valuation of the asset. It is only when everyone speaks the same language and produces a transparent set of data that the market can get a better sense of risks and benefits associated with intangible assets.

More information on intangibles will benefit management

One audience member pointed out that, in addition to the benefits noted of capitalizing internally developed intangible assets – that of providing more information to investors – another major benefit is that of providing more information to management, who would then have more information to better marshal the company’s resources. Sandy Peters agreed with this wholeheartedly, noting that it was not until pensions were accounted for on the balance sheet that companies became serious about managing their pension liabilities. As companies better understand the value drivers of their business, they do a better job of managing them.

Why hasn’t FASB addressed the issue to date?

It was noted that the standard-setters have acknowledged that internally developed intangible assets such as brands should be recognized on the balance sheet, but have not to date prioritized this as a project. The following challenges were noted in moving this project forward:

1. Lack of a “transaction” to provide a benchmark valuation

Michael Moore noted that CPAs tend to be very conservative, and that historically there has been a resistance by the accounting profession in general to write up assets, because it would result in “fictitious” capital that could not be divided to shareholders.

Along the same lines, Jennifer Hillenmeyer noted that the accounting framework generally looks to some sort of a past transaction which then provides an observable price. For example, when an intangible asset is purchased, or when there is a business combination, there is a transaction price that provides a checkpoint for the reasonableness of the value of the intangible asset. In the case of internally developed intangible assets, there is no such “transaction”.²

² In response to a question as to whether an IPO could be considered a transaction that provides a similar checkpoint for the valuation of a brand, as in the case of Facebook or Google, the FASB representative stated that this would not qualify in the same way that an acquisition would for purposes of valuing intangible assets.

Esther Mills noted that in the past decade there has been a “sea change” in terms of the amount of assets that are presented at fair value rather than historic cost, and that there is more of a recognition today that fair value is much more relevant information to investors than the historical price that a company paid for an asset many years ago. Furthermore, to the extent that financial institutions are required to value complex and exotic derivatives, the challenges in valuing these types of assets can be no greater than those posed by valuing intangible assets.

2. Need a framework to determine when a brand has future economic benefits

Jennifer Hillenmeyer noted that she was relatively unconcerned with the **ability** of companies to value intangibles, as she said the FASB typically articulates only broad principles regarding valuation, and leaves the detail and specifics of valuation models to valuation experts. Instead, she said that, in her view, a key issue to be tackled in order to move this issue forward was to develop a framework as to **when** intangibles should start to be valued.

More specifically, she noted that, in order to be recognized for accounting purposes, an asset has to have **probable future economic benefits** that are controlled by the company as a result of a past transaction. For large, established companies with well-known brands, establishing that there are probable future economic benefits of the brand is not a big issue. But for a smaller company or a startup company, the question is, at what point do you know that there are probable future economic benefits for a newly established brand? This is an area that potentially MASB can begin to address.

3. Need to determine how to account for ongoing changes in value

Jennifer Hillenmeyer also noted that when you recognize a brand as an asset, you have to decide how to account for future increases and decreases in the value of the brand. Will they be recorded as income, or recorded directly to shareholder’s equity as part of “Other Comprehensive Income”? In addition, a decision has to be made whether the value of the brand will be amortized into income periodically over time, or whether it will instead be tested periodically for impairment. So in addition to developing a framework for the initial valuation of intangible assets, a methodology must also be developed to address the accounting for the asset in subsequent periods.

4. Need for support from Finance departments

Jennifer Hillenmeyer also voiced concern about the potential **cost** to companies of valuing brands and other intangible assets, and whether companies would be willing to bear that cost. The FASB’s constituents have indicated that companies are generally comfortable with recognizing intangible assets in connection with a business acquisition because this is a one-time cost. However, recognizing internally developed intangibles would represent an ongoing cost, and many companies object to this.

In this regard, Jennifer noted FASB’s recent trend towards simplification of accounting standards, especially in the area of intangibles and goodwill. The FASB recently established a separate board for private companies (the Private Company Council or PCC) and found in response to its outreach efforts that private companies find the ongoing impairment test for goodwill, which involves an annual business valuation to be performed, to be particularly onerous. (She also added that company management does not like the “surprise” factor when an impairment test indicates that an asset must be written down in value.) As a result, there is now a new standard for private companies that permits them to amortize goodwill instead of test it annually for impairment.

Thus, she suggested that if MASB is interested in valuing internally generated intangibles, which will lead to more complexity, they must ensure that their members’ **finance** teams (i.e. not just the marketing side) are fully engaged and supportive of this effort.

Management and auditors need to assume responsibility for model inputs

Michael Moore also spoke about the recent emphasis by the PCAOB, the regulatory body that oversees the auditing firms, to hold both management and auditors more accountable for the inputs used in valuation models. In particular, the PCAOB has emphasized the need for management and auditors to get comfortable with the forecasts and assumptions (such as discount rates, weighted average cost of capital, long-term growth rates, royalty rates, and other key assumptions) used in valuation models.

Other panelists responded that the PCAOB's concerns highlighted the need for valuation models to be more standardized, and thus more auditable; and the need for auditors and management to become more educated in valuation techniques generally.

Recognition of intangible assets is not limited to brands

Jennifer Hillenmeyer also emphasized that capitalization of internally developed intangible assets would not be limited to brands, so at some point, MASB needs to think more broadly about other types of intangibles – such as customer relationships, technology, intellectual property, and the like. In asking which intangibles are most relevant to users, FASB has found that the answer depends on the user, and the industry they follow, so that there is no one key intangible asset that they have identified.

Conclusion

Overall, it appeared that there is a general desire from investors for more information about the value of intangible assets, as well as the assumptions underlying those values. At the same time, more work needs to be done to develop a robust accounting framework for the initial recognition of intangible assets as well as how to treat the assets in subsequent periods. And while it was noted that the impetus for change might come from investors, companies should make sure that their finance departments are fully supportive of the effort that will be required and the costs that may be incurred. Finally, it was noted that there is a need for greater education in building more awareness for this issue, in order to effect a paradigm shift.