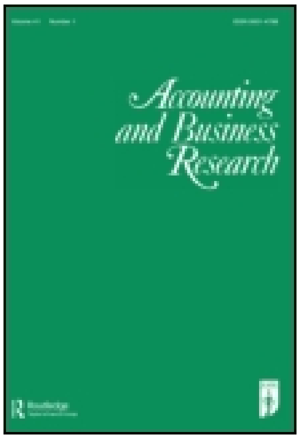

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Discussion of 'Accounting for intangibles - a critical review of policy recommendations'

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Discussion of 'Accounting for intangibles – a critical review of policy recommendations'

Peter Elwin*

It is traditional for equity analysts to criticise academics for living in ivory towers and having no concept of the hard reality that financial markets represent. However, I could not find very much to disagree with in Doug Skinner's paper. From an analyst's point of view, the question we really want to ask is: how meaningful is book value? It is easy to assert that book value has little meaning. If you compare a company's market capitalisation to its book value, and they don't match, that might suggest that one or other figure is wrong. If you think the price is broadly correct, then the book value must be wrong; the accounts must be missing something.

If you are worried about book value being fairly meaningless, then your return on any of those balance sheet numbers is also likely to be significantly devalued. Should we do something to try to improve our return-on-assets calculations?

Perhaps a better question to ask in the context of what Doug has been saying is, 'Is the current accounting model broken?' And, perhaps more importantly, 'Would fixing it make the capital markets more efficient?'

Figure 1 summarises what analysts are striving to do with financial information.

In the main, analysts concentrate on the profit and loss account not the balance sheet. However there are obviously some sectors where the balance sheet is much more important – real-estate, banks and insurance analysts all spend a significant amount of their time looking at the published balance sheets for the companies they cover, but they still look at the profit and loss (P&L) account as well. However, outside those sectors analysts do not start with the balance sheet. The balance sheet is not the answer and, frankly, never will be. It is all about income, as Sudipta's paper alluded to. It is about assessing the productivity of the business.

Current and proposed financial reporting rules require companies to book P&L items that analysts believe do not have direct economic significance in relation to share prices. Given this presumption, analysts will try to identify these items and exclude them from their 'adjusted earnings' numbers and companies respond to this by producing 'proforma earnings' figures using similar adjustments.

Clearly, that gives us a problem because we could have earnings before bad stuff, which a lot of companies like to put out – Enron being the classic example. At the other end of the spectrum we could have a potential total comprehensive income smorgasbord from which we can pick out the nice bits using Extensible Business Reporting Language (XBRL). We do not really want either of those; we actually want something that is quite hard to achieve but lies somewhere in the middle, underlying operating earnings.

A good example that shows you how far removed the focus of analysts is from the balance sheet and what accounting standards are often striving to do, is IFRS 3 and the US equivalent, and the amortisation and impairment charges relating to acquisition intangibles and goodwill that result. Do those deductions actually have any economic significance? Does it actually have any impact?

IFRS 3 requires companies to work very hard to identify acquisition intangibles and their useful lives. They have to employ specialists, at significant cost, and those specialists were not there a few years ago. This is a whole new market that has been created by accounting standard-setters, which is good news if you are one of those specialists, and good news if you are one of the auditors employed to check the methodology: they are not going to shout 'foul'. But, after all that hard work, analysts basically ignore those numbers. People find this very hard to believe but analysts and investors do not take account of the value of a customer list, partly because they know the value is very subjective and partly because it could disappear tomorrow. Likewise they ignore the amortisation of such intangibles because it tends to double count marketing costs that are already being expensed in the P&L.

I was very interested in Doug's analogy about credit analysts. Again, if you talk to credit analysts they are even more hard-nosed about this than any-

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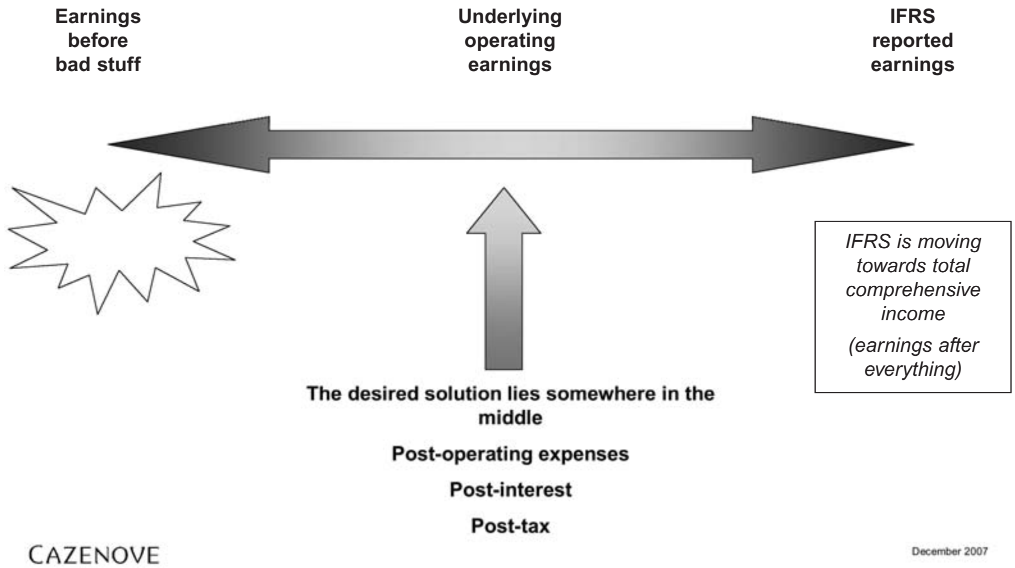
Figure 1
Background – analysts focus on the P&L, not the B/S



body else. 'Can I take it from the managers and flog it to somebody else? If I can, then it has value; if I cannot, then I start to worry.'

Equity analysts are more interested in business performance. We are not planning to take things away from managers because we are investing in them – so it is a slightly broader, more flexible approach. Fundamentally, analysts are ignoring goodwill impairments and they are ignoring acquired intangible amortisation. They are excluding those figures when they are looking at analysis of historic earnings and P&L data, and they are not trying to forecast those going forward.

They will look at things like patents, R&D, etc., i.e. intangibles where there is a reasonably clear intellectual legal framework, and a clearly defined legal life, and where they can be transferred to somebody else – licences and so on. Of course we will look at those. But the more touchy-feely things – can't trust them!

Does that mean the accounting model is broken? I think the better question, and this is an important twist to that question, is: would the cost of capital be lower if we did something about this perceived problem?

I would agree entirely with what Doug has been saying. Analysts do not want the balance sheet to tell them the market cap, because it will be nine months out of date. I can get Reuters or Bloomberg or my market-maker down the road to give me an estimate of market capitalisation now, not just then but now, and he will trade on it. So I do not need some sort of auditor/accounting standards process to tell me what the company was worth nine months ago; that is completely useless information and tells me nothing about the future. I do not want a balance sheet to give me a current value either at a particular moment in time, or even if it could be done on a real-time XBRL. 'Let us look at the general ledger; what is it worth now?' I do not want that. I trust the market to give me that information. The market gets it wrong sometimes, but that is okay.

Doug Skinner's paper says that the case for reform is surprisingly weak and does not support claims that large-scale reforms are necessary; and in particular capital markets actually function rather well in financing companies that are engaging in innovative, high-technology, knowledge-based activities. We need to rely on private incentives to encourage disclosure. That does not mean that private incentives are working as well as they should, and it certainly does not mean that all the companies are squeaky clean and tell you everything that they should, because clearly they do not; so there are some inefficiencies there. But I do not believe the solution would be to rearrange the whole accounting framework and start trying to bring more and more intangibles on to the balance sheet. In fact I am quite convinced that that is not the solution that the market wants.

Another important point to mention is the fact that the Corporate Reporting Users' Forum, an international group of sell and buy side analysts that I am a member of, wrote recently to the IASB saying: 'We know you are thinking about looking at intangibles more. Well, don't; just don't do it.' We actually said: 'We think it would be really positive if you came out with a statement that said: "We have thought about looking at it and we decided not to; we decided to spend our limited resources on something more productive."'

And I think that is one of the key things. There are lots of exciting debates we could have about intangibles, and I am sure some of you can get research budgets to do that for years and years and years – and good on you! But frankly, that is not what really matters in terms of capital market efficiency. There are some other situations that are much more broken that are causing real mispricings.

Pensions would be one of my obvious examples, because that is something I have spent the last 18 months immersed in. You have only to look at the fact that Boots could disclose a £20m surplus, and then KKR could provide £1bn of funding against the pension, to realise that there is a bit of a difference – £20m surplus or £1bn funding. There is something wrong there!

That is a much more fundamental issue, which has nothing to do with intangibles.

I agree that we do not want to change things. I do not think that intangible accounting is sufficiently broken to warrant fixing.