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Discussion of 'What financial and non-financial information on intangibles is value-relevant? A review of the evidence'

Jed Wrigley*

Introduction

The speakers at the conference identified that there is a fundamental disconnect between what we see in company accounts and what is happening in capital markets. Anne Wyatt's presentation did a good job of looking at all of the literature in this area, and further identified other work that can be done.

As accounting moves towards a more balance sheet centric view of a company, internally-generated intangibles represent the key difference between book value and the market value. These items can be allocated to a wide range of categories including goodwill, brand value, patents, research and development (R&D), workforce know-how, etc. The presenters to date have mainly been of the opinion that we should not put all of those things on the balance sheet, as they are hard to analyse, and their reliability in particular is unclear. But are accounts true and fair despite this? I think the key question is rather: 'Do analysts get the information they need to value companies properly and can it be improved?'

In the context of organic intangibles, I am very sorry to have to tell anyone that is a great supporter of full fair value of all items on the balance sheet, that I have never heard a financial analyst at two o'clock in the morning, working on their spreadsheet, trying to conclude whether to buy or sell shares of the company, saying: 'God, if only the accountants had given me the answer, I could have gone home six hours ago'. Indeed, if all of those intangible values were starting to appear on the books, I think they would argue that it would actually obfuscate the situation. The reason for this is that current intangible accounting is already weak and there are enormous problems associated with allocating value between the different intangibles and, indeed, identifying the appropriate units of account for many tangible assets.

To keep the paper to a manageable length, I will just point to three areas of accounting where we already have intangibles, where I do not think current accounting standards work: goodwill, internal intangibles (capitalisation of development costs), and accounting for acquired intangibles.

Goodwill

The issue here is that the identification of impairment cannot be rigorously tested or analysed. In my view, goodwill absolutely should go on the books of companies, and it should be looked at for impairment. Management is accountable for the price they pay to acquire another business, and in order to measure a return on invested capital we need to be able to look at the totality of what they have spent. This necessitates carrying goodwill for as long as management believe that they will earn an adequate return on the investment, followed by a charge against that goodwill if they determine that they have overpaid. The problem is it often takes new management to admit to past mistakes. So it can be quite a long time before we start to see the impact of goodwill that should have been impaired finally making it through the accounts.

Vodafone was a classic example of this. The acquisition of Mannesman and large payments for UMTS licenses had resulted in very significant intangibles being put on the balance sheet of the company. Initially, during the 'TMT Bubble', the market assumed that this value was reasonable and the shares traded at a premium to book value. Vodafone suffered in the ensuing bear market as people realised that they had paid far too much for these assets and the shares traded at a significant discount to reported book values, with analysts explaining why the book values could not earn their cost of capital. It was not until 2006, however, when they took a £23.5bn write-down that price-to-book trended back towards parity and more

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	BMW			*Volkswagen*			*Renault*		
	2003	*2004*	*2005*	*2003*	*2004*	*2005*	*2003*	*2004*	*2005*
EBITDA margin reported	13.8%	14.5%	14.6%	11.6%	11.3%	12.0%	9.2%	10.8%	9.7%
Operating margin reported	8.1%	8.4%	8.1%	1.9%	1.8%	2.9%	3.3%	5.3%	3.2%
R&D % capitalised	39%	40%	45%	44%	36%	35%	30%	38%	37%
R&D cap/sales	2.4%	2.5%	3.0%	2.1%	1.7%	1.5%	1.5%	1.8%	2.0%
EBITDA margin all expensed	11.4%	11.9%	11.6%	9.4%	9.6%	10.5%	7.7%	9.0%	7.7%
Operating margin all expensed	7.1%	7.4%	6.7%	1.4%	1.4%	2.9%	2.5%	4.6%	2.6%

Source: FIL, JP Morgan, Company Accounts

recently above. So the accounts had finally caught up.

This clearly illustrates the fundamental disconnect between accounting and capital markets as it took the management and their accountants five years to reflect market reality in the accounts and, in retrospect, earlier 'reality' in the TMT bubble had been wrong anyway.

Internal intangibles

The table above illustrates the accounting for development costs for three major car companies. IAS 38 was hoped to bring us some clarity through greater disclosure and commonality of capitalisation for this development expenditure. If done well, we would lose the divergence in accounting practice and company accounts would become more comparable, a huge potential benefit for analysts who often focus more on comparison of stocks in their coverage rather than assessing absolute value.

As the table shows the reality has been that we have ended up with every analyst having a significantly more complicated spreadsheet, because they now have to work out what was the total R&D cash spend, how much they have capitalised, the impact on operating profit this year, and how this has changed from one year to the next. As you can see here, the practice does give some strange messages. For example, BMW has gone from capitalising 39% of their total R&D spend in 2003 to 45% in 2005; Volkswagen has gone from 44% to 35%; and Renault from 30% to 37%. The proportion of R&D capitalised as a per cent of sales for those three businesses has gone from 2.4% to 3.0% for BMW, 2.1% to 1.5% for Volkswagen and 1.5% to 2.0% for Renault. These changes can cause wide divergences between profits from one year to the next and can widen the gap between cash flow and reported profits.

This divergence would be fine if we could analyse in detail what was going on and see a relationship between the development programmes and spikes in R&D spending because of a new product that is about to be launched and revenues generated later. This is the strength of accounting where we see matching of the expenditure and revenues in the income statement. But the reality is, thus far, we are unable to see a significant linkage in that area and analysis suggests that R&D cash flows are more stable than expenditure recognised through the income statement. This can be contrasted with capital expenditure and the associated depreciation expense where we see more predictable expenditure in the income statement than in cash flow.

Acquired intangible assets

When analysing non-goodwill acquired intangible assets that appear on the balance sheet, I break them down into two types: a group that I would describe as wasting assets and a group that I would describe as organically replaced assets. The wasting assets are the standard ones we might think about – patents or publishing rights. For most of these assets you can make fairly reliable estimates of the fair value. If it is a pharmaceutical company buying a patent, you can predict sales, how much it will cost you to market it and so forth, and you can come up with a value. You also know when that patent is going to expire because it has a finite life. You can therefore assess an appropriate charge for the income statement that reflects the diminution in value of the asset as it wastes. Current accounting is appropriate for these assets.

Organically replaced assets are a little bit more complicated, and customer lists are my specific 'bugbear'. If you look at the customer list that the business actually acquired, it will be a wasting asset: those same customers over a period of time will rotate off. Nevertheless, companies will organically continue to spend money on marketing, promotion and their sales force with these costs charged through their income statement. Their aim will be to at least maintain or hopefully grow their customer list organically replacing those which have wasted. The impact of current accounting is that you have a 'double whammy' in the income statement. There is a charge for the cost of maintaining that asset and you are charging amortisa-

tion against the value of the acquired asset. The reality of where we are in accounting today is that accounting standards force companies over a period of time to fade their businesses to look as if they had not grown by acquisition, whereas in reality they have, and we gradually lose sight of the assets that they bought against which we should be able to hold them accountable for generating a return.

To illustrate the issue, I will make some comments about Reed Elsevier but only because their disclosure is clearer than most. The company has made a significant number of acquisitions over the years and analysts tend to ignore the amortisation of acquired intangibles, when calculating their underlying performance, as the organically replaced assets are generally the most common component. Indeed, Reed Elsevier reports an adjusted operating profit number that is pretty compliant with what analysts tell them they want to see: operating profit before the amortisation of acquired intangible assets, and before any non-recurring items.

In 2006 a review of the accounts shows a £297m adjustment for acquired intangibles, 24% of their adjusted operating profit of £1.2bn. Included in this amount was £191m, or almost 70%, which related to content and software. It is quite likely that a proportion of these assets may indeed be wasting in nature. We cannot, from this disclosure, identify how much organic expense they are incurring to maintain some of the value of the content or indeed update and improve it, which is critical in determining the appropriate treatment to reflect the underlying economics.

For many companies, management remuneration is often linked to the adjusted profits number rather than the reported number. This might affect management decision making as they might conclude it is better to go out and buy content rather than develop it internally, because the cost of that content will go against an amortisation number that will be added back for adjusted earnings. As I mentioned before, I have used Reed Elsevier as their disclosure is clear and in their case, management have been very open when they make acquisitions about the value that they expect to generate. This is not always the case and accounting for intangibles arising through acquisitions can create problems for analysts.

Conclusion

Balance sheets need not reflect the economic or fair value of the operations for analysts and other users to reach valid conclusions when looking at a set of accounts. What is important is that we understand the operational transactions that have taken place in order that we identify what profits the management have actually earned utilising the operational capital that they have invested, organically or by acquisition. This is the 'operational stewardship' role of management.

'Financial stewardship' is slightly different. In this case we are looking at how management have performed with respect to the financial exposures of the enterprise as these can also impact on shareholder value. I am generally more supportive of using fair value for these items, which would include pensions.

One thing to think about when we are looking at this gap between capital market values and financial statements is that a level 1 valuation – the best valuation you can get – already exists for the aggregate intangibles for a business. The market cap at the year-end minus the tangible book value could be used as the value of the intangibles. There just follows an exercise in attribution of that value between the different sorts of intangible assets. The problem is that the component parts are completely subjective and I would argue that there is little point in paying valuers to make this attribution. I can illustrate this by simply taking the value of a brand. How much is genuine brand value, where customers perceive a benefit from the brand; and how much of it could be simply customer inertia? You just need to think about your own relationship with your telecommunications provider or your bank. How much of the reason that you stay with the same provider is because it is just too much hassle to change, and how much is it because there genuinely is brand value in that business? That does not mean to say that customer inertia ('customer lists'), can protect you and has long-term value, as Northern Rock recently discovered!

I should also point out that the attribution exercise is even more complicated than I have illustrated above, where I assumed that the tangible book value is a known quantity. In reality, if we move towards fair value of operating activities, the unit of account or valuation methodology can have a huge impact on the value of the tangible assets too. To illustrate: if we take the value of a factory, is the fair value the sum of the value of the land, buildings and each piece of equipment at replacement cost or is it the net present value of the cash flows arising from the production activities or even the expected disposal value on liquidation? Depending on what you choose, values will show wide divergence and the larger the unit of account, the greater the dependence on layers of assumptions which cannot really be tested. It would also mean that users would lose sight of the capital that management have invested upon which they are expected to generate a return. This would lead to a very unsatisfactory outcome and few could argue that the financial statements would be very 'value relevant' or informative despite the price-to-book being closer to one.

Some observers would argue that financial statements should reflect all the movements in fair values as this more accurately reflects the performance of management from one year to the next, measuring the success of brand building or a successful new project being completed that will deliver returns for many years. I would dispute the idea that this needs to be displayed in the financial statements, as capital markets always find a way to solve these issues. In this case the way that most businesses do it, is by ensuring that management has a significant proportion of their bonus and other compensation linked to total shareholder returns, often through share option participation and so forth. The returns maximising strategy for management will often be to grow the intangible value and communicate with their shareholders why their actions have increased the net present value of the business via improved customer retention, higher brand values, better training of their staff, richer pipeline of new products and so forth. Such communication in the management commentary should be encouraged. I know it is an area that the IASB will look at in time and believe that this is an important project to make sure users get enough information to enable them to more accurately value businesses but I do not think that the right place to carry the value of the business is in the balance sheet.

The question is: 'What is value-relevant?' To answer the question, we looked at the level of the S&P 500 compared to reported S&P 500 EPS going back over the last 130 years. This analysis gave us an R2 of 96% over this period, which seems to indicate that 'earnings' are value-relevant. I appreciate that defining earnings is complex but most analysts, investment banks and fund management groups that I talk to have a very similar view on what constitutes earnings that they are 'prepared to put a multiple on'. The IASB should focus on giving us earnings numbers, robustly defined and clearly presented.