International Valuation Standards Council

PART 1

PERSPECTIVES PAPER

TIME TO GET TANGIBLE ABOUT INTANGIBLE ASSETS

THE CASE FOR REALIGNING REPORTING STANDARDS WITH MODERN VALUE CREATION

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Time to get Tangible about Intangible Assets

Part 1: The Case for Realigning Reporting Standards with Modern Value Creation

The IVSC issues Perspectives Papers from time to time, which focus on pertinent valuation topics and emerging issues. Perspectives Papers serve a number of purposes: they initiate and foster debate on valuation topics as they relate to the International Valuation Standards (IVS); they provide contextual information on a topic from the perspective of the standard setter; and they support the valuation community in their application of IVS through guidance and case studies.

Perspectives Papers are complementary to the IVS and do not replace or supersede the standards. Valuers have a responsibility to read and follow the standards when carrying out valuations.

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Unrecognised Intangible Asset

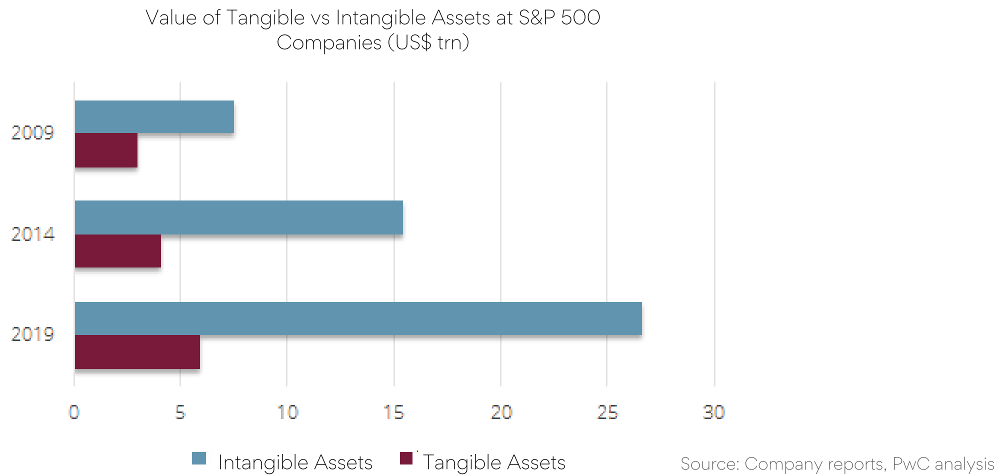
Intangible assets have long been the engine for value creation in the world's developed economies. The investment in intangible assets, both internally generated and through acquisition, is critical to an enterprises' capital allocation process. Similarly, investors' ability to identify those enterprises best able to translate such investments into long-term returns is equally as critical.

Despite the importance of intangible assets to the capital markets, only a small percentage are recognised on balance sheets, typically via acquisition from a third-party transaction.

Many have noted this severe disconnect between market values and book values (i.e., the unidentified intangible asset value[1]).

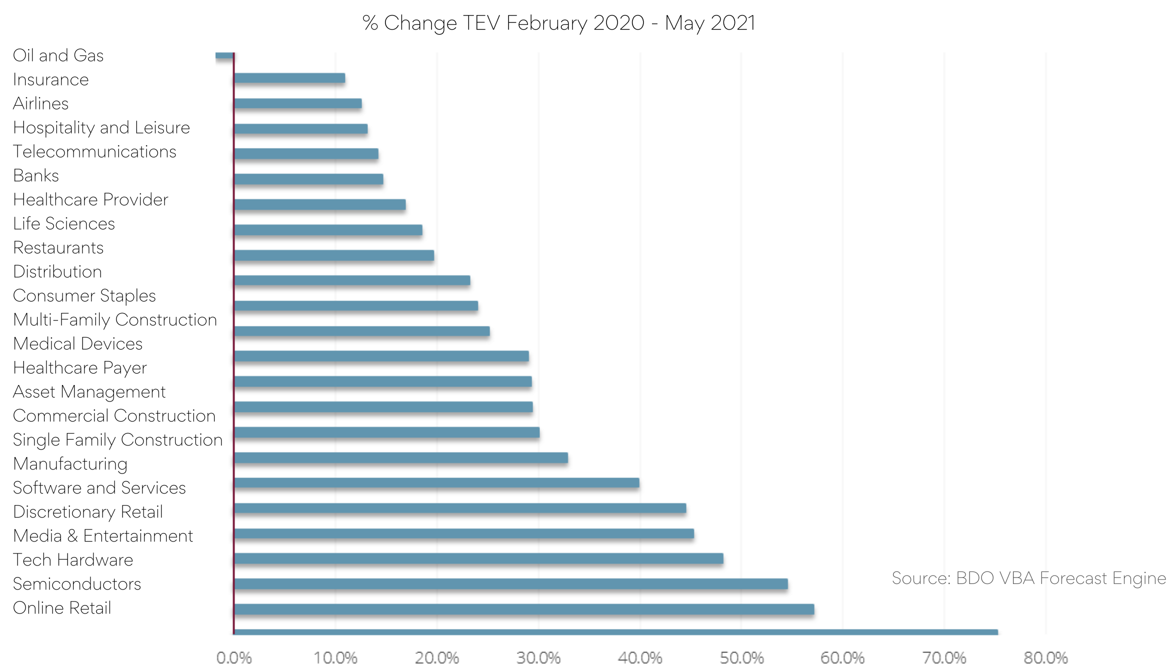
1 For purposes of this paper, we have assumed that substantially all of the market premium over book value is due to unrecognised intangible assets. However, we do note that a smaller portion of the premium is often attributed to tangible assets, as many of the depreciation regimes around the world allow or require book depreciation which outpaces actual economic depreciation.

Per *The unbalanced balance sheet: Making intangibles count*, the unrecorded intangible asset value has grown exponentially from 2009 to 2019.



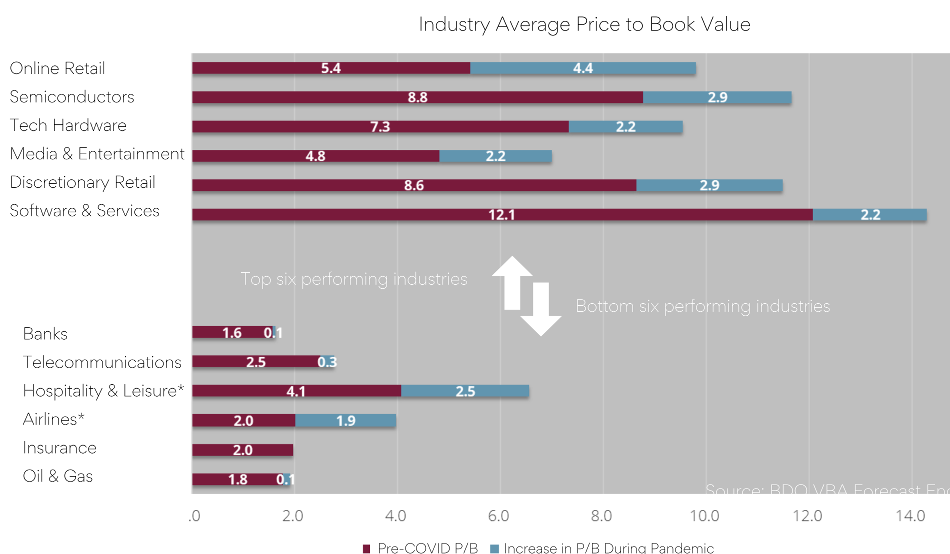
The authors state that "The increasing business focus on intangibles may exacerbate the potential disconnect between financial reporting and investing in the future." Examining data from 2020 and 2021 supports this suspicion.

Beginning in 2020, the pandemic acted to further accelerate this long-standing trend, particularly for those industries most reliant on intangible value creation, as it has fundamentally changed how people live and work. To show the acceleration of the trend in 2020 and 2021, the below graph analyses over 400 companies across 24 discrete industries and displays the change in Total Enterprise Value (TEV) from February 2020 to May 2021.



While TEV increased for 23 of the 24 industries, those with the greatest gains tend to rely most on intangible value creation.

To confirm this observation, the below graph displays the price to book value for the top six TEV performing industries and the bottom six TEV performing industries.



As you can see, there is a strong correlation between price to book and change in TEV since the beginning of the pandemic. The top six industries had an average price to book of 7.8 prior to the pandemic, versus an average price to book of 2.3 for the bottom six. Through May 2021, rising stock prices for the intangible driven enterprises caused the average price to book to rise to 10.6, an increase of 2.8. Alternatively, those that rely more heavily on tangible assets and capital that appear on the balance sheet only increased from 2.3 to 3.1, an increase of 0.8. This confirms that the pandemic has further exacerbated the disparity between market values and book values for those industries most reliant on brands, technology, and human capital for value creation.

The Impact of Unrecognised Assets

The general lack of balance sheet recognition has ripple effects through the financial statements. In the income statement, immediate expensing ignores the matching principle that governs nearly all other enterprise activities. In reaction, many companies choose to communicate various Non-GAAP measures that adjust for such activity. Additionally, failure to recognise internally generated intangibles means that such investments are largely excluded from the governance, financial reporting, and auditing ecosystems. Therefore, such investments are less likely to have corresponding disclosures or be included in the management discussion and analysis (MD&A), and

*Hospitality & Leisure and Airlines increases in P/E are largely due to the reductions in book value, as significant asset write downs and retirements occurred during the pandemic.

thus less likely to receive scrutiny from auditors or be visible to investors.

There are also practical implications for specific accounting standards, none more obvious than the disconnect between acquired intangible assets and certain internally developed intangible assets. This disconnect permeates through the impairment testing processes as well, as acquired goodwill and intangibles can be shielded from impairment write downs by internally developed goodwill and intangibles that are not reflected on the balance sheet.[2]

All told, such limitations have caused many to question the relevance of financial statements in the modern economy.[3] For example, in *The End of Accounting and the Path Forward for Investors and Managers* the authors, Baruch Lev and Feng Gu, examined the explanatory power of reported earnings and book value for market value between 1950 and 2013. Lev and Gu found that the R^2 (i.e., the explanatory power of reported earnings and book value on market value) declined from approximately 90% to 50% over the period.[4] More recent evidence from the pandemic would only suggest the trend has continued and perhaps accelerated.[5]

Given this decline in the relevance of financial statements, investors have begun to look for key information from other sources. One such area to which investors are flocking for additional information to assess value creation and preservation is ESG factors. In *A Framework to Assess ESG Value Creation*, we discussed the strong linkage between ESG considerations and internally generated intangible assets. However, there exist huge disparities in how ESG factors are disclosed and how such information is ultimately incorporated into ESG ratings. The below comparison from BDO's *The Path Ahead… Recovery Picks Up Steam*, shows the correlations between six different ESG ratings providers for over 400 companies from 24 different industries.[6]

%	MSCI	S&P	Sustainalytics	CDP	ISS	Bloomberg
MSCI		35.7	35.1	16.3	33.0	37.1
S&P	35.7		64.5	35.0	13.9	74.4
Sustainalytics	35.1	64.5		29.3	21.7	58.4
CDP	16.3	35.0	29.3		7.0	44.1
ISS	33.0	13.9	21.7	7.0		21.3
Bloomberg	37.1	74.4	58.4	44.1	21.3	

Source: BDO VBA Forecast Engine

2 For further details, see: IVSC Perspectives Paper, *Information Value of the Current Impairment Test*
3 Invitation to Comment (ITC) Identifiable Intangible Assets and Subsequent Accounting for Goodwill - CFA Institute Response, January 2020. See also: Accounting Today, *Cost versus value: Is GAAP obsolete?* December 2020
4 *The End of Accounting and the Path Forward for Investors and Managers*, Wiley, June 2016
5 BDO, Forecast Engine Industry Impact Study, Issue 1: *The Path Ahead*, pages 23-25
6 BDO, Forecast Engine Industry Impact Study, Issue 4: The Path Ahead… Recovery Picks Up Steam, pages 23-29

These disparities suggest that the ESG ratings, as they stand today, are unable to consistently convey the value creation and preservation opportunities of an enterprise. Rather, we believe the issue requires a standardised principle-based framework incorporated into the current accounting frameworks.

The good news is that others seem to be coming to the same conclusions, and there is renewed momentum in this area on multiple fronts. Recently the new Chair of the IASB noted:

> *The biggest challenge I see is to remain relevant in an ever-changing environment. … I am thinking of mega trends such as sustainability, and climate change in particular, as well as the rise of self-generated intellectual property and its non-addressal in the accounts, to name but a few. These and further issues are challenges to our work, but they are at the same time opportunities if we are willing to address them with our eyes wide open.*[7]

The IVSC Boards have concluded that the best way to aid the public discussion is by publishing a multi-part article series to explore certain fundamental questions in this area aiming to inform financial statement preparers, reviewers, and users, and aid the capital market.

Key Questions to be Answered

The limitation of current accounting standards to convey value creation and preservation activities is largely because the prevailing value creation strategies that existed when the standards were enacted decades ago, have evolved. As many current business models have evolved over decades, namely, to rely more heavily on intangible assets at the expense of tangible, the standards and the economics have become misaligned. This article series looks to contribute to realigning accounting and reporting standards with the value creation and preservation strategies utilised in modern business models. To do this, we plan to explore key questions that must be addressed, including:

- What should be the goal for an enhanced intangible asset framework? Is the goal to better identify value creation activities for future cash flow estimates, the ability to more accurately measure ROI akin to economic value-added (EVA) principles, and/or the ability to better assess managements' stewardship of capital?
- What are the intangibles that could be subject to an enhanced intangible asset framework and what investments/costs result in their creation?

7 https://www.ifrs.org/news-and-events/news/2021/07/meet-the-new-iasb-chair-andreas-barckow/

- Should an enhanced intangible asset framework be based on 1) enhanced disclosures,[8] 2) capitalisation, or 3) value creation concepts and measurement? These three options present a clear trade-off between operability and information value, but all three present a multitude of questions that require examination:
    - If disclosures prove to be the most practical first step, how can one ensure disclosures are robust and value-added?
    - If capitalisation is a viable approach, what costs would warrant capitalisation to which assets? Are certain assets better tested through impairment rather than amortised? If amortised, over what period would it be appropriate?
    - If value creation considerations are feasible, given that benefits derived from intangible assets are often not correlated with cost, is there a practical means to recognise the value created rather than cost invested?

Next Steps

We plan to help answer these pressing questions through a series of articles to follow. In our next article we will explore:

1. The primary categories of internally developed intangible assets
2. Those operating activities that give rise to each type of asset
3. How such assets generate value for an enterprise.

These insights will inform our third article where we plan to offer the beginnings of a framework to lay out:

1. Which outflows are best kept as expenses and which would be better classified as investments
2. For investments, which could be better addressed via disclosures and which are candidates for capitalisation
3. For those investments which are capitalised, for which is it more appropriate to record at cost and for which may it be possible to consider value indications
4. The potential life for amortisation and impairment purposes.

We will leverage expansive data analysis to help understand and convey the magnitude of such activities, as well as provide insights on the potential impact of any proposed framework. In addition, we plan to conduct stakeholder outreach and welcome feedback at any stage in this process.

8 For purposes of this articles, “disclosures” may include both qualitative information and/or quantitative information (e.g., additional segmentation and detail within the P&L).

The IVSC would be interested to hear your feedback on the subject discussed in this paper. Specifically, in relation to the following questions:

1. Do you believe a more aligned framework for the recognition and/or disclosure of internally generated intangible assets should be pursued?
2. Do you have any suggestions for our upcoming papers for the Board to consider?
3. Do you believe that ESG ratings, and other sources, can partially address this issue?
4. Do you agree that the economic shifts from the pandemic have further increased the need to address this topic?

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