Intangibles: The Impaired Accounting Challenge

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Abstract

This paper examines the issue of perceived value generated by the assignment of financial value to intangibles in financial reporting. In particular, values assigned to goodwill and other intangibles in mergers and acquisitions are examined, and the impact of such intangible valuations as a potential misperception/misdirection as to true underlying entity value is examined. "Perception is often the ultimate mask for reality." Attributed to the Hilliard Consulting Group, 2001

Preface and Disclaimer

Because this paper deals with material assets of claimed value, it is necessary to note nothing in this paper alleges wrong doing. Rather, the purpose of this paper is to highlight weaknesses in the accounting standards regarding intangibles, their values, their impairment, and the potential misdirection of the investing public by the permitted application of existing standards – the unintended consequences paradigm.

Keywords: Accounting Principles Board (APB), Accounting Standards Codification (ASC), American Institute of Certified Public Accountants (AICPA), Financial Accounting Standards Board (FASB), fair market value (FMV), goodwill, Gordian Knot, growth, impairment, intangibles, market share, mergers and acquisitions (M&A), profits, profit maximization, U.S. Securities Exchange Commission (SEC), sustainability, tangibles

1. Introduction

Under the U.S. Financial Accounting Standards Board's (FASB's) standards today, its Accounting Standards Codification (ASC) rules provide significant leeway as to the values assigned to net assets acquired, particularly evident in mergers and acquisitions concerning the values assigned to intangibles, in particular goodwill. Additionally, under the current standards, the wasting of those intangible asset values as expenses, provide wide discretion as to how such assets are valued and when they are expensed.

Previously, one of the largest categories of intangibles, 'goodwill', was to be amortized (expensed) over a period of time for which the asset provided benefits to the enterprise, but not to exceed 40 years. This method of dealing with goodwill was established by American Institute of Certified Public Accountants' (AICPA's) Accounting Principles Board in (APB) 17, Intangible Assets, and August 1970. This rule established a systematic and rational basis for dealing with the expensing of intangibles including goodwill, which narrowed the amount of discretion executives had; specifically, the method and the number of years over which intangibles would be expensed.

The APB 17 standard provided the basis for an annual charge against intangible assets that appeared in the Income Statement as an expense, similar to the depreciation of a physical asset, which represented the diminishment of asset value in a systematic and rational process. Thus, annual expensing of these intangible assets introduced constraints on discretion in applying the prudence and conservatism principles of accounting fundamentals at the time.

However today, the body that became the Accounting Standards Board's successor, The Financial Accounting Standards Board (FASB), has elected to follow a looser 'unless and until' impairment standard regarding intangibles. Superseding APB 17, Statement of Financial Accounting Standard (SFAS) 142, 'Goodwill and Other Intangible Assets,' June 2001, required the use of the *impairment charge method* of expensing intangibles including Goodwill. That is, goodwill was not to be systematically and rationally amortized anymore; rather, it was to henceforth be 'impaired', if and when impairment occurred. That is, intangibles were not to be expensed unless and until impairment occurred – a value as principally determined in the eye of the beholder approach. U.S. Generally Accepted Accounting Principles (GAAP) are based on its standards being systematic and rational, and not subject materially to the whim and discretion of executives' perceptions, which may sometimes be deemed arbitrary and capricious. The 'impairment rule' in use today is still the rule under the FASB's SFAS 142 as codified in its Accounting Standards Codification (ASC) as FASB Accounting Standards Update (ASU) 2012-02, issued July 2012, Topic 350.

Other intangibles of note that are subject to the same treatment today as goodwill are represented by intangible assets such as: customer lists, brand names, intellectual property, etc. As each intangible asset is unique, the fundamental problem lies in valuing (few to no benchmarks are available) and estimating a useful life. This issue ultimately becomes a discretionary judgment call by enterprise executives. The previous APB 17 rule mitigated to a large degree the discretion in the expensing of such assets.

I. Intangibles

General intangibles are defined in the Uniform Commercial Code (U.C.C) in Article 9 - Definitions, as:
any personal property that is not an account, chattel paper, commercial tort claim, deposit account, document, instrument, goods, investment property, letter-of-credit right, letter of credit, money, or mineral before extraction especially as identified by section 9-102 of the Uniform Commercial Code (n.d). More specifically and simply, intangibles are assets which have the following characteristics: "incapable of being perceived by touch; impalpable, are imprecise or unclear to the mind, or are saleable, though not possessing intrinsic productive value" (The Free Dictionary, n.d.)

FASB under its accounting authority, specifically in its Accounting Standards Codification (ASC) governing the accounting for intangibles and goodwill, sections 350-10, 350-20 and subtopic 850-30, addresses the issues of, and issues associated with, intangibles including goodwill. In particular, paragraph ASC 350-10-05-1 provides guidance on financial accounting and reporting related to goodwill. Paragraph ASC 850-30-30-1) Measurement of Goodwill, posits:

…the acquirer shall recognize goodwill as of the acquisition date, measured as the excess of (a) over (b) where (a) is the aggregate of the consideration transferred; the fair value of any non controlling interest in the acquired; the business combination achieved in stages and (b) is the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this Topic. The Accounting Standard Codification (ASC 350-10-20) also describes Goodwill, "…as an asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized." In simple terms, goodwill is generally a long term asset of an intangible nature that arises when a company acquires another business in its entirety. Goodwill is calculated as follows:

Figure 1: Intangibles - The Goodwill Calculation

Cost of the Acquisition

- Fair Market Value (FMV) of Tangible Assets Acquired

- FMV Value of Intangible Assets Acquired *Individually Identifiable*

- Value of Assumed Liabilities of the Entity Acquired

= **Goodwill**

Even more simply, goodwill is the net asset value of assets acquired in excess of their Fair Market Value that cannot be individually identified.

II. Facts and Historical Points – The Rules

Many of the issues in dealing with intangibles including goodwill arose when the former Accounting Principles Board (predecessor to the Financial Accounting Standards Board – FASB) in its Opinion, APB No. 16, 'Business Combinations', permitted two methods of accounting for acquisitions: 1) the purchase acquisition rule where goodwill had to be calculated, and 2) the pooling acquisition rule which permitted firms to simply merge like kind account balances (no write-up of asset values to fair market value). APB 16 required the pooling method to be used, but then laid out a series of rules which were difficult for firms to meet in adopting the pooling method. Unless all the pooling combination rules could be met, the purchase method had to be used. The effect was many firms had to use the purchase method for business combinations. APB No. 16 was superseded with the FASB issuance of its Statement No. 141 (SFAS 141), 'Business Combinations', which only permitted the purchase method to be used for accounting for business acquisitions. To date, the purchase method of accounting for business combinations stands.

Additionally, FASB Concepts Statement 2 (CON 2), (May 1990), Qualitative Characteristics of Accounting Information, in paragraphs 91 – 93, addresses the matter of making the conservative choice when deciding accounting matters. 91. Nothing has yet been said about conservatism, a convention that many accountants believe to be appropriate in making accounting decisions. To quote APB Statement 4: Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism. . . . [paragraph 171] 92. There is a place for a convention such as conservatism—meaning prudence—in financial accounting and reporting, because business and economic activities are surrounded by uncertainty, but it needs to be applied with care. Since a preference "that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets" introduces a bias into financial reporting, conservatism tends to conflict with significant qualitative characteristics, such as representational faithfulness, neutrality, and comparability (including consistency). To be clear about what conservatism does not mean may often be as important as to be clear about what it means.

93. Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits. The Board emphasizes that point because conservatism has long been identified with the idea that deliberate understatement is a virtue. That notion became deeply ingrained and is still in evidence despite efforts over the past 40 years to change it. The convention of conservatism, which was once commonly expressed in the admonition to "anticipate no profits but anticipate all losses," developed during a time when balance sheets were considered the primary (and often only) financial statement, and details of profits or other operating results were rarely provided outside business enterprises. To the bankers or other lenders who were the principal external users of financial statements, understatement for its own sake became widely considered to be desirable, since the greater the understatement of assets the greater the margin of safety the assets provided as security for loans or other debts.

However, the FASB with its issuance of SFAC 8, September 8, 2010, 'Qualitative Characteristics of Accounting Information' which superseded CON 2, changed its long standing practice of a preference for the conservative choice. In Para BC3.27 of SFAS 8 (also referred to as CON 8), the FASB no longer included '*prudence or conservatism'* as an aspect of neutrality. Hence, the new *…unless and until…* impairment treatment for Intangibles and Goodwill became the standard in place 'til today.

III. Discussion of the Issues

In the recent past, it was noted in Forbes Magazine (Oct. 16, 2006), when reviewing the new, at the time, FASB's Fair Value Reporting Standard, SFAS 157, Fair Value Measurements, September 2006 (now re-classed as FASB ASC 820, Fair Value Measurements and Disclosures), that large issues loomed regarding intangibles and their valuations. Here, Forbes reported that Verizon Corporation carried on its books approximately $48 billion in wireless license fees paid to the FCC for spectrum. The issue arose when the FCC subsequently auctioned off twice as much spectrum as Verizon held for approximately $14 billion.

By dividing the $14 billion by 2, we can see the FCC auctioned off approximately the same amount of spectrum as Verizon held for $7 billion – a $41 billion delta from what appeared on Verizon's books paid for licenses. Here Verizon would likely have had to show this was not a market comparable (marked to market) – our spectrum is different than the recently auctioned off FCC spectrum, and use the fall back value method of justifying its spectrum value with a net present value discounted cash flow estimation based on the spectrum held. But $41 billion is $41 billion on anyone's books, and represents a huge delta from a marked to market basis!

In more recent times, we see a tremendous growth in the appearance of intangibles on the balance sheets of many companies in order to show top line and bottom line growth in an otherwise satiated market. That is, when few green fields remain (few unclaimed customers), entities start buying others to feed Wall Street's need to see top and bottom line growth period over period in order to sustain market values. Such acquisitions in periods where margin and growth without acquisitions are being squeezed, tend to drive managements to find a way to show material top and bottom line growth other than via organic growth. Unfortunately, in such acquisitions, material layoffs often follow in order to capture accretive financial benefits.

Such acquisitions then often result in material goodwill and other intangibles (values placed on customer lists for example) appearing on the balance sheet as a percent of total assets and/or off balance sheet market values. It was reported in The Wall Street Journal that companies in the U.S. could have recorded more than $8 trillion in intangible assets (including goodwill) according to Leonard Nakamura of the Federal Reserve Bank of Philadelphia (2016). Monga states, "… that's nearly half of the combined $17.9 trillion market capitalization of the S&P 500 index (Monga 2016). Bernard Condon of Associated Press (2016) indicates that goodwill on the balance sheets of the Standard & Poor's 500 index ballooned to $2.5 trillion. "That is 50% more than at the end of the last deal boom in 2007 according to FactSet," (Condon, 2016).

The effect of the move to booking large goodwill amounts according to data provided by R.G. Associates, a research firm that focuses on accounting matters, shows that in 2002 following a surge in acquisitions, accounting write-downs cut pre-tax earnings by 21%, while goodwill write downs in the twelve months following the end of 2007 reduced S&P 500 earnings by more than 38% (Condon, 2016).

Condon further identifies the issues with goodwill values. He posits that the average premium over market prices offered by acquirers in 2015 was 38%, and for health care companies, the premium offered was 57% (Condon, 2016). To some, such premiums over market value appear as gross overpayments above what the market reflected as value.

The below Figure 2 presents reported Intangibles including Goodwill of 19 of the largest U.S. publicly listed companies with the largest goodwill. This table also presents a view of intangibles and goodwill relative to each entities total assets and market capitalization measures.

Figure 2: Total Assets, Market Caps, Goodwill and Intangibles

		Total Assets, Market Caps, Goodwill, and Intangibles							
	(in Billions of $s rounded to nearest Whole Billion for, Years ending in 2015 -months vary)								
	Sources: Forbes Magazine, June 15, 2016, www.sec.gov/edgar), & Siblis Research								
		Largest 25 U.S. Firms by Goodwill and Other Intangibles (Excluding Financial Institutions) Sorted by Goodwill as a % of Assets							
Co Name	**STK SYM**	**Date Years Ending in 2015**	**Tot Assets $ Rounded to nearest Whole Billion**	**Market $ Capitalization Rounded W/B**	**G/W $ Rounded to W/B $s**	**G/W % of Tot Assets rounded**	**Intangibles Not G/W Rounded to W/B $**	**Total G/W + Intangibles in W/B $s**	**Total Intangibles as a % of Market Cap**
Express Script Holding	ESRX	December	53	59	29	55	10	39	78
Time Warner	TWX	December	64	52	28	43	8	36	70
CVS Health	CVS	December	94	108	38	40	14	52	49
United Health Group	UNH	December	111	112	44	40	8	52	47
Procter & Gamble	PG	June	130	221	45	37	25	70	32
General Dynamics	GD	December	32	43	11	36	1	12	30
Mondelez International	MDLZ	December	63	71	21	33	19	40	57
Honeywell international	HON	December	49	80	16	32	5	21	26
Walt Disney	DIS	October	88	174	28	32	7	35	20
United Technologies	UTX	December	88	85	27	31	16	43	51
HP	HPQ	October	107	21	33	31	2	35	167*
Oracle	ORCL	May	111	156	34	31	6	40	26
Tyson Foods	TSN	October	23	16	7	29	5	12	75
IBM	IBM	December	111	134	32	29	3	35	26
Pfizer	PFE	December	168	199	48	29	40	88	44
Anthem	ANTM	December	62	36	18	29	8	26	72
3M	MMM	December	33	93	9	28	3	12	13
Lockheed Martin	LMT	December	49	67	14	28	4	18	27
AT&T	T	December	403	212	105	26	121	226	106

***Note: HP's numbers above are distorted due to the breakup of HP into two separate enterprises in this period.**

As an example of the growing issue regarding the size of intangibles on balance sheets, viewing one large firm in the table above which has been in the news of late, AT&T, it can be seen AT&T had total assets of approximately $403 billion, and goodwill of approximately $105 billion (by far the largest goodwill dollar amount amongst the firms examined) for the year 2015. It is noted that this goodwill sum grew by approximately $31 billion in just one year alone – principally because of AT&T's DirecTV acquisition. Moreover, it had other intangibles of $121 billion for a total intangibles amount of approximately $226 billion, or 106% of its December 31, 2015 market capitalization, representing approximately 56% of total assets. If we subtract intangibles from total assets ($403 billion - $226 Billion = $180 billion) we see intangibles comprised approximately 126% of other assets. AT&T's total intangibles alone exceeded its market capitalization by approximately $14 billion. Compare that goodwill amount ($105 Billion) above to the former AT&T's approximately $2 billion in goodwill on approximately $60 billion in assets in its December 1998 annual report to shareholders, and we see an explosive expansion in intangible values. One analyst estimates with the Time Warner acquisition, AT&T's debt will increase from $119 billion in 2016 to $170 billion (Knutson, 2016). Something has dramatically changed, perhaps in part because of the change in business combination and impairment standards regarding intangibles today. And recently in 2016, AT&T announced its planned acquisition of Time Warner for approximately $108.7 billion -$85.4 billion in cash and stock with the remainder in debt assumption (Hagey, et al, 2016). One can only imagine how much intangible 'value' will be added to AT&T's balance sheet after Time Warner's net assets are written up to fair market value.

However, this acquisition also raises another important matter regarding intangible values. Most of AT&T's DirecTV's customer base pays at the high end of the pricing spectrum for television and cable like programming subscription services – an average of $117 a month (Gryta, 2016). AT&T has announced plans to offer DirecTV Now services based principally on Time Warner's programming content via streaming Internet services for $35 a month, initially for 100 channels with a free Apple TV provided. Premium services are estimated to be priced at $50 to $60 per month when available (Gryta, 2016). This begs the question, how many customers will migrate away from AT&T's higher priced DirecTV to its new lower priced DirecTV Now services? And what will such migration to AT&T's DirecTV Now (or competitor services from the likes of Netflix, Hulu, Sling TV, et al) do to the supposed value gained in the DirecTV acquisition of just over one year ago? Will not this DirecTV Now offering along with like kind competitive offerings materially and negatively impact the value of AT&T intangibles?

As an asset, goodwill appears to help the acquirer in a business combination in sustaining the appearance of increasing enterprise value via increased assets, and in the firm's ability to show top and bottom line increases through additional revenues with no concomitant penalty in the form of additional expenses (goodwill and other intangible asset impairment/expenses). What develops is a pattern of constraints wherein a primary, almost single focus on sustained growth and profit maximization ultimately leads to entity non-sustainability by placing gross overpayments for assets above net asset fair market values on the balance sheet. That is, long term sustainability may be negatively impacted in entities that pay large premiums over market values for net assets acquired above fair market value by showing such overpayments as assets versus period or transaction expenses. In concept, it could be said that managements and Boards of Directors are induced to grossly overpay for net assets acquired because there are material gains: enhanced enterprise valuations, positive stock price performance, an increased ability to borrow or raise other capital, and an ability to reward managers and employees with ever increasing 'in the money' options, etc. But the question remains, do such overpayments above market values enhance or limit sustainability?

Monga (2016) in The Wall Street Journal cites the work of economist Carol Corrado. Corrado shows that companies were investing approximately 14% of the private sector gross domestic product into non-physical assets (intangibles) in 2014. The investment in tangible assets (physical matter) in 2014 was approximately 10%. Corrado posits this was a reverse of the situation of 40 years ago where investment in tangible assets was 13%, and intangibles was 9%. Clearly technological advancements have had an impact in the type of investments made; but 40 years ago, intangibles including goodwill had to be systematically amortized (expensed) over not more than 40 years – a dramatic difference with the intangible's impairment (expense) standards of today.

IV. Possible Reasons for the Growth in Intangibles including Goodwill

Why might managements see the gross over payment above fair market value for net assets acquired as a tool of value – and top and bottom line enhancements? Simply, when in the second half of the life cycle in any industry, it becomes harder and harder to capture new un-captured customers. Hence growing a top and bottom line via organic growth becomes much more arduous than in the first half of the respective business life cycle. And, as Wall Street principally only rewards top and bottom line growth and market share gains period over period, firms in maturing markets need to show growth and increases in the top line and bottom lines above all else. And with intangibles not having to be systematically expensed, managements have a window of opportunity to drive for the brass ring – top line and bottom line growth, with no concurrent material acquisition overpayment expenses appearing on the income statement. This possible willingness to grossly overpay for net assets acquired above fair market value is even more likely so if CEO and CFO tenures are examined. Fortune Magazine reported that for the 500 largest companies in the U.S., the mean tenure for a CEO is 4.9 years (Sonnenfeld, 2015), and for CFOs, The Wall Street Journal reported the mean tenure was 5.6 years (Monga, 2015). Hardly a tenure long enough to worry about sustainability and the long term!

In the market as a function of time, if a primary focus on profit maximization is followed driven by an understanding of mean tenure times for senior officers, it almost universally will lead to corporate decline or demise – short term growth and profit maximization versus longer term sustainability strategies and actions. And if we consider the short life cycles of a business enterprises averaging 12.5 years (Shore, 2013), here too we see relatively very short lives as in the mean tenure times of the CEO and CFO. Strong incentives for immediate gratification.

V. Conclusions and Recommendations

More assets on balance sheets today are of an intangible nature (including goodwill) than at any previous time. Clearly, technological changes may be at the center of this shift in asset form, but it also appears that accounting standards have created a large inducement for companies to 'puff the value wares' by permitting for an overpaying (premiums above market value) for net assets acquired in a business combination without such goodwill and other intangible assets being systematically amortized (expensed). Inasmuch as the impairment standards still provide wide discretion in their calculation even in the latest FASB draft regarding the impairment of intangibles, in order to return to the accounting underpinnings of making the prudent and conservative choice, the following is recommended:

1) Modify the FASB ASC 805 Business Combinations standard (and associated standards as needed) such that any premium paid by a successor entity for a business in a business combination above the market value as represented on a main stock exchange on the day before the proposed acquisition or merger is announced, be expensed upon deal closing . This would mitigate the large increases in intangibles created under current standards. And it would highlight how much management paid over the net fair market value of net assets acquired.
2) Reintroduce into the Statements of Financial Accounting Concepts (SFACs) the prudence and conservatism underpinnings in accounting previously found in FASB's CON 2.
3) Reintroduce the rational and systemic amortization of intangibles (excluding patents and copyrights, etc. if they have a statutory remaining life greater than 20 years) over a period not to exceed 20 years.

These recommended changes should help unmask gross overpayments above market values seen in business combinations of the past ten years and rationally and systematically expense intangibles over a reasonable period of time considering today's shorter life cycles.

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Terms and Acronyms

10K – SEC required annual financial reporting form
10Q – SEC required quarterly financial reporting form
AICPA – American Institute of Certified Public Accountants
APB – Accounting Principles Board (the precursor to the FASB)
ASC – Accounting Standards Codification
ASU- Accounting Standards Update
BCG – Boston Consulting Group – Quad Model: Mix Max/HiLo Framework: Market Share/ Market Growth Matrix (Adapted)
Cash Cows – BCG mature company/product/service component with large market share, but little growth opportunities where cash flows are used to fund faster growing components
Dogs – BCG units, products or services which no longer provide required growth, profits, cash flows, and have little market share.
High Potential - BCG model high growth components that are gaining in market share
Winners – BCG model components with the highest market share and market growth
CONs – FASB Concept Statements now termed SFACs
FASB – Financial Accounting Standards Board (successor to the APB)
FMV – Fair Market Value
GAAP – Generally Accepted Accounting Principles
SEC – U.S. Securities and Exchange Commission
SFAC – Statement of Financial Accounting Concepts