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ACCOUNTING FOR IDENTIFIABLE INTANGIBLE ASSETS: NO ONE RIGHT WAY

by

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Abstract

This paper considers the conceptual basis for various arguments as to the most appropriate method of accounting for identifiable intangible assets. The conceptual framework propounds the view that information needs of users have primacy. One consequence of this is that shareholders' views should be considered. Partial results of a major survey of the shareholders of Pacific-Dunlop Ltd, undertaken by the authors, are drawn on. These results indicate that shareholders have a variety of views regarding the accounting for identifiable intangible assets. A conclusion is drawn that in order to meet the information needs of the users, no single method should be prescribed.

Accounting for Identifiable Intangible Assets: No One Right Way

Introduction

The purpose of this article is to explore the arguments surrounding the most appropriate method of accounting for identifiable intangible assets such as brandnames and mastheads. There is considerable controversy as evidenced not only by the range of methods adopted by Australian companies (see Tibbits 1991) but also by various recently published papers (Carnegie & Gibson 1989, Thornton 1989, Reilly 1989 & English 1990). Phase one of the discussion will examine the conceptual framework and its implications for accounting for identifiable intangibles. Whilst conceptual analysis will provide direction given the underlying concept of accounting (historical cost, modified historical cost, continuously contemporary accounting, current cost accounting), the initial choice of concept remains an unresolved question. One possible approach to resolving such an impasse is to ask users of financial statements to see whether there is a dominant view across all classes of users. This article provides a partial exploration of that question by examining the views of a range of different shareholders categories[1].

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1 Data reported and discussed in this paper is drawn from a major survey undertaken by the authors.

The Conceptual Basis

The Australian Conceptual framework sees general purpose financial reports focusing `on providing information to meet the common information needs of users who are unable to command the preparation of reports tailored to their particular information needs.' (SAC 2 par.7). Further it considers measurement of performance as one of those information needs. Thus `disclosure of revenues generated by the entity during the reporting period and the expenses incurred in generating this revenue, together with the assets, liabilities and equity of the entity at the end of the reporting period, will provide users with information to assist them to assess the financial performance of the entity over the reporting period' (SAC 2 par 29) Further `the financial position of the reporting entity involved disclosure of information about its control over resources, financial structure, capacity for adaptation and solvency'. Finally, the information presented must satisfy the qualitative characteristics of relevance, reliability and materiality (SAC 3).

However the conceptual framework does not yet resolve the issue of whether the information is to be measured on a historical cost basis or on a current value basis. Traditionally accounts in Australia have been prepared on a modified historical cost basis, so historical cost will be discussed first.

Historical Cost

Each asset purchased is viewed as the purchase of a bundle of units of service potential which are to be used up over an extended period of time. Thus a motor truck might be viewed as providing 100,000 kilometres of service. If in the first year the vehicle provides 10,000 kilometres of transportation then one tenth of the expected diminution in value between purchase and disposal should be charged as an expense, and the net book asset reduced accordingly. If money is spent on repairs that would be charged as an expense of the period. However if an outlay represented an enhancement of the asset, such as the purchase of a special tray for the truck, then that would be added to the asset value.

If the purchase of a brand name is viewed in the same manner, it is an asset with a finite life which should be amortised so that each period is charged with the units of service potential which were consumed during that period. There is no doubt that the reputation or image which was purchased will only attract customers for a limited period of time unless action is taken to sustain that image. According to this line of argument the purchased brand name should be amortised over its expected life.

The issue then focuses on the efforts to sustain the brand name. Part of the advertising budget of the organisation would usually be designed to reinforce and sustain the brand image. Under historical cost accounting those outlays which give future benefits (such as prepaid insurance) should be treated as an asset to be matched against the period which benefits from the outlay. On that basis, the proportion of the current outlay on brand advertising which benefits future periods should not be charged as an expense but rather treated as an addition to the asset. The difficulty arises in identifying the portion of the outlay which represents current consumption and that portion which provides future benefits. Let us suppose a firm has a purchased brand name costing $500,000 less the amount amortised to date of $200,000. Further suppose this firm believes that $80,000 of the current outlay on brand advertising represents future benefits. Then the asset should conceptually be recorded at $380,000. This could be checked by comparing the historical cost to the asset market value. If the market value was $370,000 then that would represent the best evidence as to the future benefits and hence would set the <u>maximum</u> historical cost valuation allowable. In that case a further $10,000 would have to be written off as an expense. If the market value came out at $400,000, then under historical cost accounting the conceptually correct valuation would be the $380,000 being the costs which are providing future benefits of $400,000.

Whether the brand advertising should be treated as an asset revolves around the conflict between relevance and reliability. There is no doubt that these allocations are very relevant in terms of the given objective of measuring performance and control over resources. Questions are raised as to how much reliability can be placed on the allocation of cost to future periods, and whether the market value test provides adequate external evidence of sufficient reliability to create confidence in the resulting calculations.

The conceptual framework does not provide any assistance in the resolution of this conflict. If the resolution is that there is not sufficient evidence, then advertising expenditure will not be carried forward, and the appropriate method of accounting will be to amortise purchased brand names. If the resolution is in favour of cost allocation, then the transfers of advertising to future periods will offset the amortisation. The practical effect (although not strictly correct as a conceptual definition) is that the asset will be revalued each period with the changes in value being recorded in the profit and loss statement.

Modified Historical Cost Accounting

Historical cost has been criticised for the fact that following periods of inflation the assets in the balance sheet may substantially understate the current worth of the asset. To provide more current asset amounts accountants have adopted a form of modified historical cost, even though there is little conceptual basis for this mixture. This method is condoned in official documents, including AAS 10 Accounting for the Revaluation of Non-current assets. Under that standard:

par 29 `Where a class of non-current assets is revalued, the net revaluation increment or decrement in respect of that class of assets shall be accounted for as follows:

(a) an increment shall be credited directly to an asset revaluation reserve - except that, to the extent that the increment reverses a revaluation decrement previously recognised as an expense in the profit and loss or other operating statement in respect of the same class of assets, it shall be revenue in the profit and loss or other operating statement for the reporting period; and

(b) a decrement shall be recognised as an expense in the profit and loss or other operating statement except that, to the extent that the decrement reverses a revaluation increment previously credited to, and still included in the balance of, an asset revaluation reserve in respect of the same class of assets, it shall be debited directly to that revaluation reserve.'

The implication is that if the above method is being used for other assets, then for internal consistency the same approach should be used for brand names.

Current Values Approaches

Obviously there are a number of current value approaches. An article on one type of assets is not going to solve the current value debate. Accordingly this article will consider briefly two of those approaches.

The concept of continuously contemporary accounting would be consistent with the objectives of the conceptual framework in so far as it provides up to date information on the assets under the control of the organisation, the capacity to adapt and the revenue and expenses (resources consumed) during the period. Chambers (1991) contends that it would also be consistent with the information needs of users. Under continuously contemporary accounting all assets would be valued annually at their current cash equivalents and the gains and losses would flow through the profit statement.

The current cost accounting approach would, in the view of many accountants, also be consistent with the objectives of the conceptual framework. Under that approach asset revaluations upwards would be recorded in reserves and the decrements and annual amortisation would normally be charged to the profit statement. The supporters of this approach would argue that:

(1) It would indicate the control over productive resources in terms of current entry or replacement cost prices.

(2) It would indicate the surplus resources generated during the period after allowing for the consumption of resources in current entry or replacement cost prices.

(3) It would indicate the sustainability of the productive endeavours which would indirectly indicate the wisdom of paying dividends and thence influencing solvency.

Other approaches could also have been considered but the above seems adequate to demonstrate the range of possibilities.

The Ability of the Conceptual Statement to Resolve the Issue of Accounting for Identifiable Intangibles.

The above discussion focuses on the following major issues:

(i) that the objective of financial statements is to serve the needs of users who do not have the power to command the production of reports specifically tailored to meet their needs,

(ii) that the conceptual framework leaves the question of trade-offs between various qualitative characteristics unresolved,

(iii) alternative methods of accounting can also be fitted into the conceptual framework by making different trade-offs.

It appears therefore that the issue of the most appropriate method of accounting for identifiable intangibles requires a direct approach to users.

The Relevant Users

Who are the relevant users is not a simple issue.

Ijiri (1983) has argued that the views of all potentials users should be reflected irrespective of whether they use the information or not. The mere knowledge that information of appropriate quality and quantity is available should they want it, is sufficient to create the level of confidence necessary to continue supporting that type of investment.

A similar viewpoint can be held on ethical grounds - the mere fact that a company has accepted a shareholder's investment obligates them to provide information which the shareholders can understand irrespective of whether they actually decide to use it. (Ruland 1989)

An alternative school of thought is that the production of information is a resource consuming exercise and can only be justified if the benefits from its use exceed its production costs. According to this approach information is directed to those users with the knowledge and the inclination necessary to make significant use of the information (Beaver 1973).

The choice between the various approaches is not resolvable on conceptual grounds. Perhaps empirical evidence may assist.

User survey

To gain insights into the attitudes of a major potential group of users, a survey was conducted of the shareholders of a large Australian company, Pacific Dunlop Ltd. The sample surveyed consisted of 50% of shareholders with 5000 shares or less, one form to each nominee shareholder, and a complete survey of all other groups of shareholders.

The response rates are set out in Table 1.

Table 1
Response Rates

Category	No of Total Returns	% of Total Returns	Response Rate
Holders of 5000 shares or less (approximately $25,000 or less)	3787	56.3	18.0
Holders of more than 5000 shares	1588	23.6	20.0
Overseas shareholders	582	8.7	18.0
Employee shareholders	356	5.3	6.0
Company executives	335	5.0	14.0
Nominee shareholders	75	1.1	11.0
Total	6723	100.0	16.0

The attitudes portrayed by respondent shareholders to the most appropriate method of accounting for intangibles are outlined in Table 2.

Table 2

Opinions on the Most Appropriate Method of Accounting for Identifiable Intangible Assets Such as Brand names.

Category	Record at cost without adjustment	Record at cost less annual amortisation as operating expenses		Annual Valuations Adjustment to			Other Methods	Did not express an opinion		
		Amortisation over estimated life	Amortised over life or 20 years whichever is the shorter	Operating profits	Extra ordinary items	Reserves		No Opinion	Do not understand	Did not answer
5000 shares or less	307 8.1%	449 11.9%	555 14.7%	184 4.9%	269 7.1%	323 8.5%	112 3%	1053 27.8%	386 10.2%	149 3.9%
over 5000 shares	134 8.4%	202 12.7%	305 19.2%	60 3.8%	104 6.5%	162 10.2%	53 3.3%	388 24.4%	107 6.7%	73 4.6%
Nominees	7 9.3%	15 20.0%	13 17.3%	2 2.7%	8 10.7%	6 8%	3 4%	17 22.7%	2 2.7%	2 4.0%
Executives	28 8.4%	44 13.1%	51 15.2%	38 11.3%	40. 11.9%	28 8.4%	7 2.1%	78 23.3%	18 5.4%	3 .9%
Employees	38 10.7%	29 8.1%	30 8.4%	32 9%	13 3.7%	36 10.1%	4 1.1%	93 26.1%	69 19.4%	12 3.4%
Overseas shareholders	53 9.1%	80 13.7%	83 14.3%	30 5.2%	40 6.9%	59 10.1%	17 2.9	163 28%	29 5%	28 4.8
Total	567 8.4%	819 12.2%	1037 15.4%	346 5.1%	474 7.1%	614 9.1%	196 2.9%	1792 26.7%	611 9.1%	267 4.0%

What is interesting in this table is that no opinion was the dominant response in every category.

In 5 out of 6 categories the second and third ranks included both annual amortisation over the estimated life of the asset and over the estimated life subject to an upper limit of 20 years.

If those who adopt the argument that all users' views are important were forced to choose one method, this would be to amortise the asset over its life with a twenty year limit. However they would also legitimately point out that there are a number of other methods which attract substantial support.

The large proportion of employee shareholders who did not express an opinion on this issue is noted. Given the increased use of employee share schemes, the adequate communication of financial information must become an important priority.

As mentioned previously not all theorists would be interested in the responses of all shareholders. Rather, those who view the process as one of cost benefit trade-offs would tend to focus on those shareholders who were likely to use the information being presented. Consistent with, but not identical to, that concept, it would be appropriate to seek the views of shareholders who consider the method chosen is significant.

In this instance, shareholders were asked:
"Assuming the accounting method used is disclosed in an understandable way, how important to you is the method chosen by Pacific Dunlop Ltd to

account for each of the items listed below". One of the items was identifiable intangible assets on acquisition. The questionare provided for the response on a five point scale ranging from unimportant to important. Table 3 outlines the preferred method of accounting for identifiable intangibles such as brand names by those respondents who saw the method chosen as very important.

Table 3
Appropriate Method of Accounting
As Viewed by the Very Important Subgroup

	Number	Percentage
1. Record at the purchase price less annual amortisation, or write off, to operating expenses in the profit and loss account. The write off being spread over the expected life of the brandname etc, or twenty years, whichever is the shorter.	262	21
2. Record at the purchase price less annual amortisation, or write off, to operating expenses in the profit and loss statement. The write off being over its estimated useful life.	196	16
3. Annual valuations of brandnames etc, including purchased and internally generated. The valuation adjustments to be included in shareholders' equity as a reserve.	177	14
4. I have no opinion.	165	13
5. Recorded at the amount which was paid to purchase and the brandname etc, without adjustment.	139	11
6. Annual valuation of brandnames, etc, including purchased and internally generated. The valuation adjustments to be treated as extraordinary items in the profit and loss account.	103	8
7. Annual valuations of brandnames, etc, including purchased and internally generated. The valuation adjustment to be included in the calculation of operating profits.	88	7
8. I do not understand the question.	64	5
9. Other.	39	3
10. Not answered.	21	2
	1254	100

Once again the prominence of the historical cost approach as well as the substantial support shown for other methods is noted.

It is possible to consider whether the above result reflects indoctrination in traditional methods of accounting. This question was addressed by classifying respondents into those with and without formal accounting qualifications, (see table 4). For the total population of those without formal accounting qualifications, and where a choice was made, the most popular choices were to capitalise purchased brandnames and then to follow the matching concept in amortising the cost.

Table 4
Methods Nominated by Persons Who Do Not Possess Formal Accounting Qualifications

	Number	Percentage
1. No opinion.	1579	30
2. Recorded at the purchase price less annual amortisation, or write off, to operating expenses in the profit and loss account. The write off being spread over the expected life of the brandnames, etc., or twenty years, whichever is the shorter.	627	12
3. I do not understand the question.	559	11
4. Recorded at the purchase price less annual amortisation, or write off, to operating expenses in the profit and loss statement. The write off being over its estimated useful life.	547	11
5. Recorded at the amount which was paid to purchase the brandname, etc., without adjustment.	449	9
6. Annual valuations of brandnames, etc., including purchased and internally generated. The valuation adjustments to be included in shareholders' equity as a reserve.	385	8
7. Annual valuations of brandnames, etc., including purchased and internally generated. The valuation adjustments to be treated as extraordinary items in the profit and loss account.	341	7
8. Annual valuations of brandnames, etc., including purchased and internally generated. The valuation adjustment to be included in the calculation of operating profits.	267	5
9. No response.	184	4
10. Other.	131	3
	5089	100

Conclusions

The survey indicates that the most popular methods amongst the shareholder respondents were to capitalise purchased brandnames with the intent to systematically amortise the asset over its life or twenty years whichever is shorter. This held for all categories of shareholders except nominees. It also held when only the views of those who considered the method of accounting important were examined. Those without formal accounting qualifications also preferred that approach. However, there was almost equally strong support for amortisation over the life of the asset without a twenty year limit. In fact four methods could be said to have reasonable support.

Thus whilst the most popular method was consistently supported, it only achieved 25.6% support of those expressing a choice of accounting methods, or 15.4% of all respondents. One conclusion drawn is that one single method for accounting for intangibles should not be prescribed if accounting is to be seen as a means of providing users with information . A second conclusion is that accounting has failed miserably in communicating with shareholders. Thirdly, to implement the fundamental objectives as stated in the conceptual framework, the profession needs to do more surveys of users, to establish their information needs, rather than imposing the profession's views on users. The survey referred to illustrates that such an undertaking is feasible.

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