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Shareholders none the wiser as SFAS 141 has a minimal impact

The major accounting initiative designed to improve the reporting of intangible value in the US was supposed to bring greater clarity. But a new study shows that SFAS 141, like IFRS 3, has failed to live up to the hype

By **Thayne Forbes**

Over five years have passed since the inception of the US Statement of Financial Accounting Standards 141 Business Combinations (SFAS 141) in 2002. One would expect there to have been marked improvements in the reporting of intangible assets since then. However, this does not appear to be the case.

There is an increasing focus on the value of intangible assets to a business, something that has been highlighted in recent years with their importance to the significant increase in mergers and acquisitions activity. Investors and shareholders are becoming more sophisticated in their demands for company information and want to know what they are investing in. Management and boards are being held more openly accountable for strategic decisions around new business ventures and their potential economic contribution. And with up to 90% of some business' value attributed to intangible assets, this requires particular attention.

As a result, SFAS 141 set out to enhance reporting and disclosure of business combinations, particularly relating to the value of intangibles. One of its key purposes was to standardise the accounting method of business combinations as use of different methods was confusing. Users also wanted more clarity around the value of intangibles being acquired. In this respect, SFAS 141 requires more transparency and the separate disclosure of goodwill from other intangible assets based on specific criteria.

Corporations reporting under US accounting standards have been required to apply SFAS 141 to all business combinations from 1st July 2001. In a drive for globally consistent accounting, International Financial Reporting Standards Number 3 on Business Combinations (IFRS 3) was introduced in 2005 and is adopted by larger quoted companies in the UK and throughout Europe (see IAM issue 21, pages 8-12, January 2007). SFAS 141 and IFRS 3 are similar in very many respects.

We have reviewed the reporting of the value of intangibles under SFAS 141. We did this by studying the annual reports and 10-K filings of the US corporations making up the current Standard & Poor's 100 (S&P 100) index between 2002 and 2006 to see how this compares with UK companies reporting under IFRS 3. We highlight our conclusions on the reporting of the value of intangibles below:

- The benefits of this reporting appear insignificant.
- There has been no apparent improvement in the quality of reporting in the last five years.
- There is little difference from reporting under IFRS 3.

Some of our considerations supporting these conclusions are now are summarised out below.

Hundreds of billions swallowed up by unexplained goodwill

In five years the 100 largest US corporations reported 212 major acquisitions valued at US$1,033 billion in total. Net tangible assets were reported at US$253 billion (24%) and total intangible assets at US$780 billion. Of these, US$290 billion were identified (28%) and almost two-thirds, US$490 billion, remained as goodwill (48%).

Our focus is on the identification and valuation of intangible assets and the balancing figure, the black hole of goodwill – a black hole because no description or analysis is given of what this value includes. It is effectively an unaccounted for difference or balancing figure.

The reality is that this is more likely to include intangible value, assets which are not to be valued under the accounting standard (ie people) and basic overpayment for the business perhaps justified by synergies. However, there is no analysis which would help a stakeholder understand this because SFAS 141 (unlike IFRS 3) does not require any disclosure of what constitutes goodwill. The annual reports by and large contain no meaningful information in this area and yet only a basic amount of disclosure would enable readers to at least form some understanding of the issues. Business combinations are often highly significant and it is reasonable to expect that stakeholders should at least have some top level information to help them gauge whether it was money well spent.

Much of the goodwill is likely to be capable of meaningful analysis, such as synergies and people. This in itself acts as a useful cross check for whether the valuations of intangibles are reasonable – the residual value for goodwill and the value of the other intangibles are directly linked to each other. For example, Pepsi Cola acquired the UK snack brand, Wotsits, and other smaller brands in 2002 for US$400 million of which US$200 million was allocated to the brand and less than US$100 million to goodwill. Identified intangibles were 86% of total intangibles. Pepsi Cola's 2003 annual report outlined its growth strategy in terms of the acquisition of smaller companies which complement its existing businesses and have the potential to enter new geographies and product categories. The acquisition of Wotsits clearly fitted with PepsiCo's growth strategy and these explanations at least give a rationale for residual goodwill, which was not so relatively significant in this instance.

However, in contrast, Proctor and Gamble's (P&G) acquisition of Gillette for US$53 billion in 2005 gave rise to intangibles including goodwill of US$65 billion. Of this, 46% was identified as marketing related intangibles but that left US$35 billion of goodwill. When P&G's annual report is reviewed, some rationale supporting this can be found from gains in post acquisition synergies both in reducing costs and extended sales opportunities. But, these were not quantified or analysed in depth. In this case goodwill is so significant that it needs to be analysed and explained so that an informed view can be made of the accounting for the acquisition. As it is, US$35 billion is pretty much unexplained and is instead just called goodwill. As the accounting standard, SFAS 141, does not require explanation of this it really indicates the need for improvement in the accounting standard. Company reporting is, of course, often driven by the requirements of accounting standards.

So it is a serious shortcoming of the current US accounting standard that acquiring corporations are not required to explain quantify and analyse the major elements of residual goodwill that they propose to capitalise as goodwill. More transparency of such reporting will also have the benefit of ensuring that acquirers, their advisers and auditors look more closely at the values attributable to the component parts of goodwill, and reduce the risks of overpayment for acquisition targets being overlooked.

Overstated value

Not only is goodwill a significant black hole, but we believe US corporations are overstating its value. This may be due to two reasons:

- A failure to identify and value some separable intangible assets. This is due in part to a lack of knowledge and confidence in appreciating the true commercial value of intellectual property, as well as the fact that the accounting standard is not enforced effectively.
- A deliberate undervaluation of separable intangible assets. This would be done largely to reduce the risk of annual impairment testing requiring a charge to profits if value is lost whereas an increase in value is not recognised; thus

Figure 1. **Assets and goodwill in major US M&As, 2002-2006**

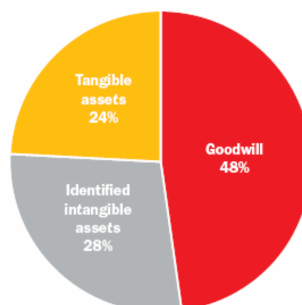
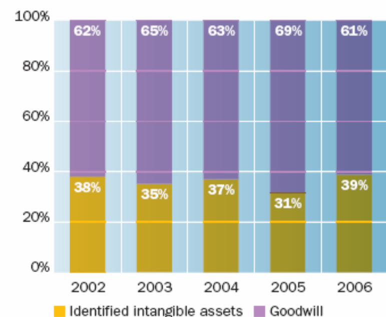


Figure 2. **S&P 100 2002-2006 purchase price allocation**



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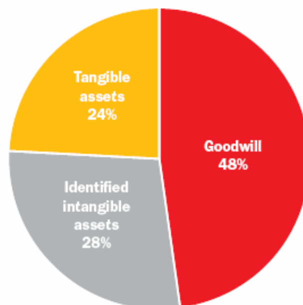

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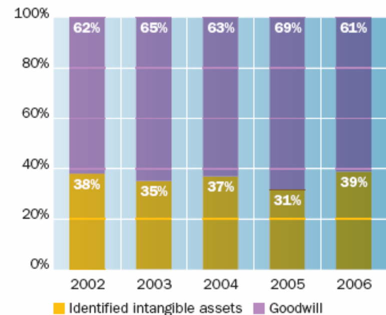
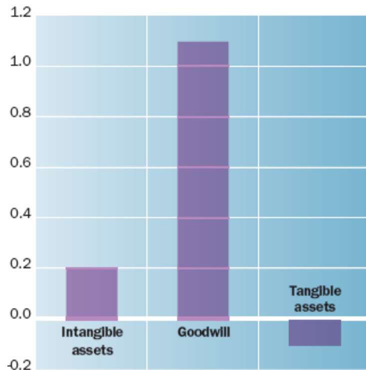


Figure 3. **Purchase price allocation on Google's acquisition of YouTube**



incentivising management to undervalue intellectual property.

An interesting measure of the adequacy of reporting of intangible assets is the proportion of identifiable intangible assets as a percentage of total intangible assets. Although just one measure, it is a good overall sense check on what has been reported. The totals reported by asset category by year, together with the percentage split between identified intangible assets and goodwill, are summarised in the table on page XXXX. To avoid skewing results with data from a small number of vary large deals, we calculated the percentage of identifiable intangibles for each transaction and have summed these percentages.

Over the last five years the average percentage of identified intangible assets from total intangible assets has ended up at 36%. This mirrors our findings for the FTSE 100 companies in the UK, reporting under IFRS, with 36% identifiable intangible assets (note that this simple arithmetic mean figure hides a very broad range and the most frequently reported percentages are in the 20% – 35% range. There are also significant acquisitions with either 100% identified intangibles or 100% goodwill).

As residual goodwill is that part of the purchase price allocation (PPA) which is left after all the tangible and identified intangible assets have been fair valued, a high proportion of residual goodwill left (with minimal explanation) means there is a risk that there has been either a failure to identify and/or fully value intangible assets. Or it could mean that there has been an overpayment for the acquisition

There could also be a desire to minimise exposure to amortisation and impairment charges. Some intangible assets, such as a contract, have rather short lives, so giving rise to substantial charges to profit from amortisation of the value of the contract over its remaining useful life. Brands, on the other hand, often have an indefinite lifespan and therefore are not subjected to amortisation. However, intangible assets with indefinite lifespans run a higher risk of impairment and an embarrassing write-down of the brand's value. This is because brand values must be tested individually and cannot be aggregated with other assets to take advantage of the ability to offset impairments against other gains.

In contrast, goodwill does not have to be amortised so there are no charges to profits to explain. It is also tested for impairment, but unlike intangible assets goodwill can be aggregated into large lumps called cash-generating units and these can include parts of the acquirer's existing business. In this situation it is possible to have impairments in one area against gains in others. This much reduces the risk of impairment and clearly provides an incentive to leave as much of the purchase price as possible in goodwill.

Google and Walt Disney examples

Some corporations have overpaid for acquisitions and these overpayments have usually been reflected in the goodwill figure. This often comes to light in subsequent years and management is usually reluctant to admit that such mistakes have been made. A recent example indicating the potential for this is Google's acquisition of YouTube for US$1.2 billion in 2006, something which created headline news in the brand valuation market.

Of the total acquisition, only US$200 million was allocated to intangible assets and 92% remained as goodwill. We all know that the success of YouTube is largely down to its brand name's ability to attract subscribers, yet the valuation given for its brand name is extremely low at only 8% of the total acquisition price. Without analysis and explanation of the goodwill figure it does look like there is a significant unaccounted for overpayment.

Similarly, Walt Disney paid US$7.5 billion for the digital animation studio, Pixar, which created *Toy Story*, *Finding Nemo* and other classics. The intangible assets, mainly trademarks and trade names, were only valued at US$200 million and goodwill at US$5.6 billion. It is hard to believe that intangible assets could be valued so low, even though the skilled workforce of Pixar is a key asset that Walt Disney wanted to acquire and both the US and IFRS standards on business combinations specifically exclude workforce from recognisable intangible assets. Again, without analysis and explanation of the goodwill figure it does look like there is a significant unaccounted for overpayment.

The same across time, and the big four audit firms

It appears that there is little or no visible improvement in the quality of reporting since the inception of SFAS 141. Good intentions to standardise and make accounting for intangibles transparent are still far beyond reach. Sadly, the same conclusion applies to the UK FTSE 100 companies reporting under IFRS 3.

We also looked at the percentage of identifiable intangibles reported on by the big four audit firms, Deloitte & Touche, Ernst & Young, KPMG and PWC, and found little variation between them. The acquisitions audited by all four had identifiable intangibles in the range of 29%-36% of total intangibles on a sum of percentages basis. So our issue is a general one and not confined to some of the main audit firms.

Immateriality used to avoid relevant reporting

Adding further to the failures SFAS 141, materiality has been used to avoid reporting under it in cases where it is clearly germane.

The numbers of acquisitions for which a PPA was reported by the S&P 100, including groups of smaller acquisitions reported in aggregate, averaged only just over 40% of all acquisitions made between 2002 and 2006.There are a small number of US corporations that do report PPAs for small acquisitions.

The reason given for this inconsistency is that the application of materiality varies from one company to another. There is no strict definition on what constitutes materiality and no baseline has been set to suggest that companies should report a PPA on an acquisition if it is above a certain limit. Therefore, there seems to be a great deal of latitude on whether or not a PPA should be reported on smaller acquisitions.

Wells Fargo, a financial services company with a market capitalisation of US$117 billion, concluded that acquisitions priced at US$6.8 billion and US$4.1 billion in 2002 and 2003 respectively were immaterial and therefore did not require disclosure of PPAs. A materiality level of 6% of market capitalisation may be deemed immaterial by Wells Fargo, but investors may not think the same.

General Electric (market capitalisation US$353 billion) deemed that two acquisitions costing more than US$11 billion in 2005 and 2006 were immaterial and reported no PPAs.

What this suggests is that there is no useful or common standard on materiality:

Hope for future improvement?

Some might find these view challenging or upsetting, but they need to be expressed as a first step towards recognising problems, so that improvements can be made. However, SFAS 141 should not be dismissed as useless. Of the reports that we reviewed, there were a handful of corporations that demonstrated a good grasp of the concept of transparent reporting and adopted it through a more robust application of SFAS 141.

There are six categories in which intangible assets must be identified: (1) contract; (2) customer; (3) marketing; (4) technology; (5) mixed; and (6) artistic related. A company is thus able to categorise its intangibles into relevant areas. We found that US corporations have been better at allocating value to these categories than those in the UK, with 9% mixing categories compared with their UK counterparts at 13%. This is encouraging and raises some hope of achieving better reporting of intangible asset values.

In 2003, Lehman Brothers acquired private wealth and asset management group Neuberger Berman for US$2.9 billion. Customer relationships were valued at US$800 million, other intangibles a further US$200 million and goodwill US$1.9 billion. Although goodwill represents 66% of total intangibles, Lehman Brother recognised that customer relationships are a substantial asset.

Similarly Sprint's merger with Nextel for US$45 billion showed a better application of SFAS 141. Under SFAS 141 rules, Sprint was deemed as the acquiror and in the purchase price for Nextel, US$41 billion represented intangible assets. Of the US$41 billion, 62% was identified as contract and customer related intangibles.

Judging by this, it is not all doom and gloom. There is plenty of reason to believe that corporations will look towards achieving improvements in the future reporting of the value of intellectual property.

Where financial reporting should go

The three pyramids on page XXXX visually capture the treatment of goodwill and intellectual property, and the impact the financial standards have had as well as the opportunity for the future.

It is interesting to see the progression of the quality of reporting of intangibles over

Figure 4. **Allocation of intangible assets and goodwill by auditor**

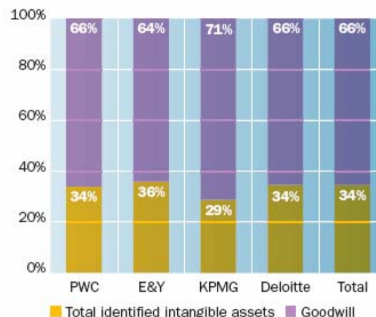


Figure 5. **Acquisition cost with no PPA reported as a percentage of market capitalisation**

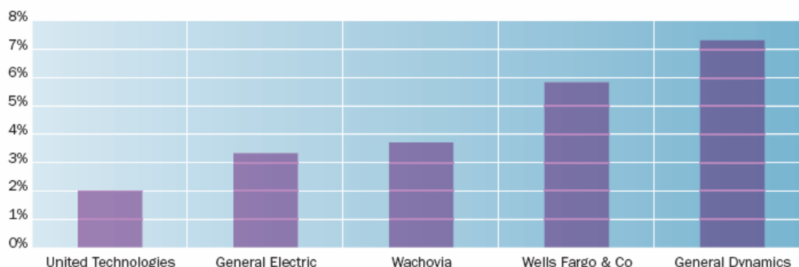
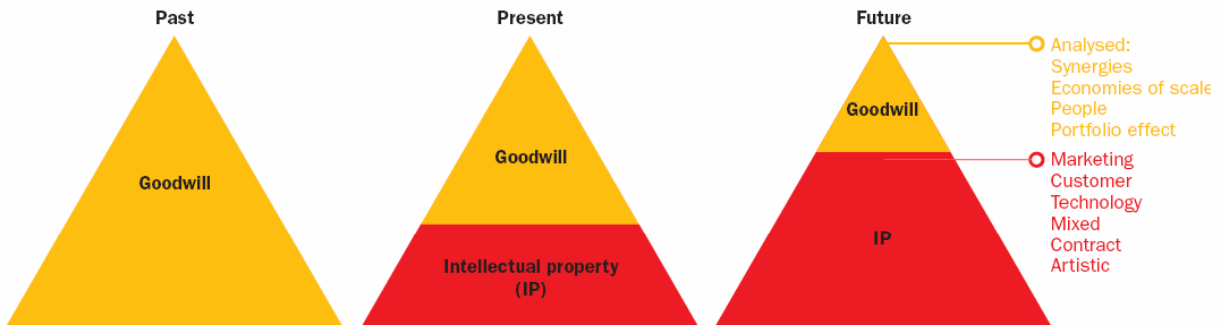


Figure 6. **Intangible reporting pyramid**



time. Prior to the introduction of SFAS 141 in 2002, goodwill engulfed the whole pyramid where there was no quantification of intangibles, making it difficult to recognise their commercial value in items such as brand names. Since the inception of SFAS 141, there have been some attempts to quantify and value intangibles, and reduce the proportion of goodwill. However, the reporting of intangibles could be much better than it is today. For example, the proportion of goodwill sitting at the top of the pyramid in Present SFAS 141, representing an average of 48% across a range of industries shown in our study after applying the accounting standard, has great room for improvement.

There were a few examples that illustrated a good application of SFAS 141 found in our study. But the handful that are there cannot really prove that the inception of SFAS 141 has made the accounting for intangibles more explicit. There are several gaping holes in the standard that desperately need addressing. The lack of requirement to describe and analyse what is in goodwill is a fundamental flaw in the standard. This paves the way for accountants to be creative in their valuations. An incentive for accountants to minimise amortisation and impairment charges is almost like a get out clause for under-valuation of intangibles or overpayment in acquisitions. In addition, it gives scope for disguising over payments in unexplained goodwill. Such attractive incentives need to be removed.

For these reasons, it is no surprise that the proportion of goodwill remains painfully high. Our findings show that overall:

- US corporations have not been better at reporting intangibles, hence resulting in amounts of goodwill that are too high; while the level of analysis of goodwill is too low.
- The quality of reporting is similar to that found among large UK companies under IFRS 3.

The reasons for this are wide ranging. Intangibles are not all being properly identified and some may be allocated low valuations. Overpayment for acquisitions is almost certainly to be applicable in some cases and nothing is given which helps recognise or identify this.

On a lighter note – and worth paying attention to – is that there is always hope for better reporting, especially while there is an accounting standard in place. Admittedly, we do not live in a perfect world and as corporations are still getting to grips with fully adopting SFAS 141, we must give them time to implement it properly. Five years may seem like a long time but a new standard will take time to be embraced fully, especially in industries which have traditionally avoided placing values on intangibles.

SFAS 141 certainly has the potential to grow into a more effective accounting standard and once fully appreciated, accountants will be able to apply the standard more easily and be able to offer management and investors a much higher quality of reporting. Transparent reporting will answer more questions about mergers and acquisition activities. Management and investors will have high level information with which to justify and understand strategic business decisions.

One day we hope that this type of analysis will become the rule. It would be quite a milestone.

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