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Cutting to the heart of financial reporting 'The Globe and Mail Metro (Ontario Edition)'

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Adding intangible assets such as brand power to a company's book value requires remaking decades of accounting theory Consultant Christopher Snider has an observation about the world's most valuable companies.

"What do they all have in common? For one, they all have terrific brands. Apple, Microsoft, McDonald's, Toyota, Facebook. They all have great brand value. Why? These companies all have strong human, customer, structural and social capital."

He has another, related observation.

"If you look at the balance sheets of all of these companies, the book value of these companies is a fraction of what they're worth," he said Wednesday in a webinar for valuation professionals. "The book value of the company's assets is usually a fraction of the market value of the business."

Mr. Snider's view, an increasingly common one, cuts to the heart of financial reporting: Do balance sheets do a good job of communicating a company's worth? For Mr. Snider, who advises privately owned companies, the answer is no, and the solution is easy: The CEO of the Ohio-based Exit Planning Institute sets aside the financial statements produced for tax purposes, and helps the business owner arrive at a "real number" every quarter that typically involves putting a current market value on all the company's assets, whether it's real estate or a corporate brand.

No such option exists for the publicly traded company, or for the investors who buy its shares on the Toronto Stock Exchange or any of the other of the world's bourses. While some financial assets are "marked to market [value]" every quarter, the productive assets of most companies are placed on the balance sheet at their historical cost – easily verifiable via contracts or invoices – and depreciated over time. Accounting rules prohibit outright the listing of intangible assets that are internally developed, such as the brands listed above, on a balance sheet.

This is prompting calls for a reassessment that runs counter to decades of accounting theory – and worries many analysts and accountants, who see the value in the rules that create today's balance sheets.

Brand Finance, a Britain-based consulting firm, recently teamed up with the Chartered Institute of Management Accountants and the Institute of Practitioners in Advertising to do a survey of analysts and chief financial officers. The result: 68 per cent of analysts and 58 per cent of CFOs thought all internally generated brands should be separately included in the balance sheet and that all intangibles should be revalued each year. Brand Finance CEO David Haigh calls it "clear evidence that both producers and users of financial [statements] want to see a radical change in the antiquated way intangible assets are reported."

Mr. Haigh, a chartered accountant, says: “I’ve been in the brand-valuation business for 25 years, and when we started the general view was that it was all just black magic and hocus pocus … and most of the big accountancy folks laughed us out the door.”

Everything changed for him in 2004, he says, with International Financial Reporting Standard 3, which governed accounting for business combinations and included rules similar to U.S. and Canadian generally accepted accounting principles: When one business acquires another, it must calculate a fair market value on the acquired trademarks and intangible assets and list it on its balance sheet.

The rules, however, apply only to acquired intangible assets, not to ones developed by a company. “I think now there is a general consensus you can value these things – the only thing is they say, ‘Well yes, you can value them, but no, you can’t put them on the balance sheet.’ ”

In essence, Mr. Haigh says, “it’s a mixture of external information, financial valuation techniques, management opinions of what you can do with them, and you put them all together and come up with what you would call a fair market value.”

While Mr. Haigh primarily calls for the inclusion, and frequent revaluation, of intangible assets, he’s also a fan of marking-to-market tangible assets, such as real estate. “Buildings, you can argue, are not really tangible assets. They’re a stream of earnings based on what they can be rented out for … the real value of a building incorporates a lot of intangible value.”

Al Rosen, director of forensic accounting at Toronto’s Accountability Research Corp., says it’s the management judgment element of this argument that’s particularly troubling to him. “The idea that allowing these types of values onto the balance sheet will somehow increase transparency is completely backwards,” he says. “Intangible assets are notoriously difficult to value, and internally generated intangibles would be even worse. If anything, financial transparency decreases the more that management estimates are introduced.”

“This issue is not new,” ***Anthony Scilipoti*** of ***Veritas Investment Research*** adds. “The problem is investors want accountants to do all the work for them. And the further we get away from historical cost, the greater the volatility and subjective nature inherent in the reported results. … The answer is not new standards, it is a better understanding of existing standards.”

Norman Rothery, publisher of value stock newsletter the Rothery Report and a Globe and Mail columnist, says price-to-book ratio can be useful for investors, but preferably as just one of many metrics and valuation tools. “I know of very few people who only use price-to-book, or price-to-tangible-book, and most value investors will make adjustments to balance sheets before calculating the ratio,” he says.

“I don’t think much of the idea of frequently updating intangibles,” he adds. “Over all, it seems like the idea would generate large fees for the accountants and other helpers, only to result in highly questionable numbers. After all, how much is Coke’s brand worth? Would different estimates be in close agreement or would they vary wildly? And how much is the Trump brand worth?”