CL 133

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International Accounting Standards Board
30 Cannon Street, London EC4M 6XH
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Re: Amendments to IAS 36 and IAS 38 – Exposure Draft

Dear Ms. Kimmitt and the IASB,

Congratulations on a big step forward in the treatment of intangible assets in the exposure draft for the amendments to IAS 36 and IAS 38. You have made some very good improvements. Given that intangible assets and goodwill are almost two-thirds of the market value of the average stock, this is definitely a critical area.

I know that the comment deadline for the exposure draft was the 4th of April and that this date has passed. In June I was in Norwalk, Connecticut meeting with the FASB as part of a financial accounting policy committee that I am on, and I hadn't realized the status of this project. However, I sincerely hope you will consider the ideas in this letter.

As a bit of background, I worked for Deloitte & Touche for about ten years, primarily in the Corporate Finance and Valuation Group, where I was a senior manager. During my time with the group, I performed over a hundred purchase price allocations that involved the valuation of intangible assets, and I was considered one of the leading experts in intangible asset valuation nationally. Currently, I am working in industry with a large manufacturing company where I work on corporate development and internal financial analysis projects.

I believe that these ideas are not biased in any way, and I am writing because I care a great deal about trying to improve the way things work in this world.

BROAD COMMENTS

I have a couple broad issues I would like to discuss first, and afterwards I will present my specific comments. Primarily these comments relate to IAS 38.

Useful Lives

The rules here should be very simple. If an intangible asset can be capitalized (i.e., related expenditures are removed from the income statement, then placed on the balance sheet to be amortized and spread in the income statement over time), it should be amortized (and thus have a finite useful life). On the flip side, if related expenses can't be capitalized, then the asset shouldn't be amortized (and thus there should be an indefinite useful life). However, one can't mix the two rules – otherwise there is a gross mismatch.

This becomes clearer when one looks at the balance sheets. Previously trademarks were amortized, yet there was no mechanism to capitalize the expenses used to maintain or enhance that value. Thus, under the prior rules, if the Coca-Cola Company were purchased and its trademarks (assumed here to be all of intangible value) were amortized over twenty years, the value of the equity would be written down from its current market value of $115 billion to the $10 billion in book value of hard assets. This never made sense, and, thankfully, the amortization treatment was fixed.

Unfortunately, for some reason, the simple amortization/capitalization rules mentioned above were not then applied across the board to other intangible assets. Under FAS 141 and 142, for example, balances for buckets called customer relationships and patents are amortized, yet there is no capitalization of the expenses that are spent to maintain those asset groups. Thus, after a period of time, the balance sheet will show that a healthy business has no customers and no patents.

Certianly the existing patents at the time of acquisition will diminish in value, yet the company will also be incurring expenses to develop new ones that aren't being capitalized and thus not added to the bucket. Likewise with existing customer relationships. If an existing customer relationship asset is being amortized, then things like selling and marketing expenses that are replenishing and maintaining the asset should be capitalized. Otherwise, leave the expenses in the income statement and don't amortize.

Furthermore, from a market value perspective, the market value of a typical business is expected to increase or remain stable over the long term. The value would remain stable if the company pays out all of its net income (really free cash flow, but close enough) to shareholders; the value would be expected to increase if the company retains significant portions of its earnings to reinvest in the business. This is in direct contrast to the current rules which effectively show the market value of the typical business starting to decline immediately after acquisition. The culprit is the incorrect amortization charge.

If an intangible asset is going to be maintained by expenses in the future, or if the intangible asset was not previously capitalized during the normal course of business, there should be no future amortization, since doing so would double count expenses.

By adhering to and not mixing the simple rules of amortizing when one capitalizes and not amortizing when one doesn't capitalize, this will fix some serious errors in the current standards. Furthermore, this would also help get rid of a major inconsistency between companies that have made acquisitions and those that haven't in the presentation of their financial statements.

A bit of food for thought: If an intangible asset can't be capitalized during the normal course of business, why should the same asset be put on the balance sheet just because of an acquisition?

Consistency

Because of the improper amortization expenses, there is also a major inconsistency between the income statements of businesses that have made acquisitions and those that haven't. If a business is acquired and afterwards shows a lower net income due to amortization, is the economic income for that business really that much lower? Of course not. The problem is that unless the intangible assets were capitalized prior to the acquisition, the subsequent amortization charge ends up double counting expenses.

For those that think that the amortization of intangible assets that have no capitalization method is justified, then what would they say about the earnings of current companies? Are all those earnings really overstated because they are missing an amortization charge? Why should changing the presentation of a company's balance sheet to make book equity equal to the market value of equity at a point in time create new charges that can substantially lower what is supposed to represent economic income?

Valuation

Having seen and worked with numerous valuation models for specific intangible assets, I have been impressed by the wide variety of approaches and models used to value the same asset. An existing customer relationship valuation model, for example, may have different charge methods for the use of other assets, different base amounts (EBITDA, EBIT, or net income) that the charges are applied to, and varying intangible asset premiums that are added to the average cost of capital, to name a few. Even if one uses a standard model, there still may be a significant amount of latitude in the range of supportable values.

Although I am an expert in intangibles, when I see balance sheet amounts for intangible assets for other companies that we are looking at purchasing, I don't pay much attention to the numbers. Even though knowing the underlying assumptions might help in my own analysis, there are so many different ways that people can generate balance sheet amounts, that the amounts themselves don't say much. For untrained users who may believe that the intangible valuation amount has the same degree of certainty as the accounts receivable balance, the effect may even be harmful.

Furthermore, many intangible assets are so integrated into the business that it is difficult to separately identify them. Does a particular patent or trademark, for example, really warrant a three percent royalty rate, or is there other know-how and processes involved that aren't patented? It is often very difficult to sort out.

Because of this, I strongly believe that there should be no identification of separate intangible assets on the balance sheet. Instead there should simply be a discussion of the significant intangible assets by management and a disclosure of any key pertinent factors. For example, this might include the customer turnover (and any broad stratification if appropriate) for customer relationships, and, for trademark and patent intangibles, a range of marketplace royalty rates for roughly similar products. Even if there were no discussion at all of the intangibles, no balance sheet amounts would be superior given the complexity and variation in the models.

SPECIFIC COMMENTS

IAS 38

Question 1 – *Identifiability.* As per my previous comments, I seriously question the value added of having separately identifiable intangible assets on the balance sheet. I do, however, believe that more disclosures around intangible assets would be helpful.

Question 2 – *Criteria for recognizing intangible assets acquired in a business combination separately from goodwill.* Following my comments above, intangible assets cannot be reliably measured (with the possible exception of an assembled workforce). Furthermore, presenting intangible asset numbers on the balance sheets as firm numbers adds unnecessary complexity to the financial statements, it is misleading to users, and it does not present any useful additional information.

Question 3 – *Indefinite useful life.* I agree completely that this is appropriate. Most, if not all, intangible assets should have an indefinite useful life for many businesses. Again, the rules should be simple: amortize assets in areas where expenditures can be capitalized; don't amortize assets in areas where expenditures can't be capitalized.

Question 4 – *Useful life of intangible asset arising from contractual or other legal rights.* Unless additions to the value of the intangible asset can be capitalized, these assets too should have indefinite useful lives.

For example, the pharmaceutical giant Merck & Co. has an equity market capitalization of approximately $140 billion and a book value of about $19 billion. Thus, if all the assets were marked to an estimate of fair market value, the intangible assets and goodwill on the balance sheet would increase by $121 billion. Merck is a business that relies heavily on its bucket of patents, and, although the company only has about $2 billion of patents on the balance sheet (due to acquisitions), it is safe to assume that a large portion of the difference between book value and market value is the existing patents.

If Merck were acquired and subjected to the rules of FAS 141 and 142, there would be a massive new addition to expenses in the form of patent amortization. Yet if Merck remained a standalone business, those expenses would be nonexistent, as they are now. What gives? Going back to the simple capitalization rules, the mixing of the two separate rules causes a huge problem.

Again, the distinction between a specific intangible asset within a bucket and the bucket or category itself is critical. While specific assets are certainly going to have a limited useful life, the bucket itself will in most cases have an indefinite life, since expenses like research and development are constantly adding new specific assets to replenish and maintain the value of the bucket.

Somehow the concept of remaining economic life seems to have muddled people's vision enough so that they have lost sight of basic accounting procedures for capitalization and amortization.

To reiterate, the purpose of capitalizing expenses and then amortizing or depreciating them is to spread out over time those expenses. If related expenses were never pulled out of the income statement in the first place, and then they are somehow amortized (say by FAS 141 and 142), the amortization effectively double counts the expenses. This is a major flaw in 141 and 142 that urgently needs to be rectified.

Question 5 – *Non-amortization for intangible assets with indefinite useful lives*. There is absolutely no question that this is appropriate. Most intangible assets should have indefinite useful lives since their value is either being maintained or enhanced by expenses throughout the year.

Other

- Paragraphs 55 and 56 (internally generated brands, mastheads…) – I agree completely with this treatment. You might want to add customer relationships here to make sure that this is clear. In FAS 141 there is a distinction that is made.

Thank you for your time and consideration. Please call me at 770-495-5123 or 404-846-8360 (home) or email me at cwaldorf@msn.com if there is anything I can add or help clarify.

Sincerely,

Chris Waldorf