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PURCHASED GOODWILL AND MARKETING ASSETS IN THE SNA

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Executive summary

1. Intangible non-produced assets (AN.22) in the 1993 SNA are currently classified according to the following four categories:

Patented entities (AN.221)
Leases and other transferable contracts (AN.222)
Purchased goodwill (AN.223)
Other intangible non-produced assets (AN.229)

2. This paper provides the recommendations of the Canberra II Group on assets currently classified to the third and fourth categories. The remaining categories will be the subject of further issues papers to be provided by the Canberra II Group.

3. 1993 SNA defines purchased goodwill as:

"The difference between the value paid for an enterprise as a going concern and the sum of its assets less the sum of its liabilities, each item of which has been separately identified and valued" (Annex - Definition of assets, p.310).

However, it does not describe the economic nature of the goodwill asset or explain the reasons behind the different calculations it requires for corporations and unincorporated entities. Goodwill is often described as the extra value of assets used in combination, reflecting the value of corporate structures, an assembled workforce and management, corporate culture, distribution networks and customer base. These assets are likely to be present in all businesses, but 1993 SNA, like business accounting, only includes them when their value is evidenced by a business sale.

4. Other intangible non-produced assets (AN.229) are described simply as:

"Intangible non-produced assets not elsewhere included" (1993 SNA Annex - Definition of assets, p.311).

Examples of the assets to be recorded here are not provided, although it has been assumed that the category encompasses brand names, logos, domain names, franchise rights and the like. A reference in Annex 1, paragraph 69 supports this when it refers to 'payments for services of trademarks and franchising in respect of other non-produced assets'. However, more recently Eurostat has recommended that EU member countries record mobile phone licences in this category[1]. These other intangible non-produced assets referred to in 1993 SNA could be described collectively as 'marketing assets'. Although they are identifiable in principle as a separate group of assets, in practice the boundary with purchased goodwill is blurred and a separate market value will often not be available.

5. The Canberra II Group discussed issues surrounding the recording of goodwill and marketing assets at three separate meetings and reached a consensus view on their treatment. Some changes and clarifications are proposed. None have them have any implications for the production or income accounts.

6. ***Recommendations of the Canberra II Group:***

i) An asset class 'Purchased goodwill and marketing assets' should replace the existing 'purchased goodwill'. Marketing assets is the name given to brand names, logos, domain names, franchise rights and the like[2].

ii) The economic nature of purchased goodwill and marketing assets should be clarified along the lines presented in this paper.

iii) Valuation principles for purchased goodwill and marketing assets should be applied consistently, irrespective of whether the entity is a listed or unlisted corporation, a quasi corporation or is unincorporated. They should be calculated as the excess of the purchase (or takeover) value of a business over the value of the other assets and liabilities otherwise identified in the SNA system for that business.

iv) Internally generated goodwill and marketing assets should continue to be excluded, except when their value is evidenced by a sale. In the case of internally generated goodwill, this occurs only with the sale of a business. In the case of marketing assets it can also occur with their independent sale.

v) The assets should continue to be classified as non-produced assets, even though their value is often driven by productive activity. However, further consideration will be given by the Canberra II Group to whether a term can be found that better reflects the nature of these assets. This will be addressed in the issues paper concerning Classification and terminology of assets (Issue 27).

vi) The assets should not be amortised at a predetermined rate but made subject to an impairment test consistent with the international accounting standards for these assets.

7. **Possible issues for discussion by the AEG**

[1] See Eurostat news release No 81/2000 – Eurostat decision on the allocation of mobile phone licences, Annexe 1.

[2] What should be included in the 'other non-produced intangible assets' category and whether this category is still required is another issue (number 13) and will be the subject of an issues paper for consideration at the next meeting of the AEG.

i) Do members agree that purchased goodwill and marketing assets should be combined in the one asset category called 'purchased goodwill and marketing assets'?

ii) Do members support the definition and description of purchased goodwill and marketing assets in this paper?

iii) Do members support the use of one definition of purchased goodwill regardless of the legal structure of a business?

iv) Do members support the continued exclusion of internally generated goodwill and marketing assets from SNA, except when evidenced by the sale of a business (i.e. so called 'purchased' goodwill) or the sale of a marketing asset?

Background

8. A review of the recording of goodwill and other intangible non-produced assets, such as brand names, trademarks and logos in the 1993 SNA is part of the mandate of Canberra II Group. It is generally recognised that the discussion of these assets along with a number of other intangible assets remains relatively undeveloped. Reliable estimates for these assets also tend to be absent from national balance sheets because of the estimation difficulties encountered.

9. The goodwill asset is also associated with a lack of clarity about the economic meaning of 'net worth' in the balance sheets of the financial and non-financial corporations sectors.

10. The potential significance of these assets is indicated from estimates of brand value provided by the firm Interbrand. They estimate the world's top 5 brands alone to be valued at over US$250 billion in 2003. Accounting profession journals also refer to the growing recognition that brands are one of the most important assets in a corporate portfolio. Franchising has become a widespread way of doing business and is a means by which a business can lease its brand, business processes and rights to sell branded products.

11. The Canberra II Group discussed this topic in detail at three separate meetings. Discussion papers were provided by the Australian Bureau of Statistics. The recommendation of the Group is that the purchased goodwill item in SNA should be extended to include marketing assets, the nature of the assets should be clarified and some minor changes made to make the calculation consistent for both corporations and unincorporated enterprises. There was little support for more substantial change at this time involving the recording of internally generated goodwill and marketing assets other than those evidenced by a market transaction. The proposed treatment is consistent with international accounting standards.

The need for clarification or change in 1993 SNA

12. There are a number of deficiencies with the treatment of purchased goodwill and other non-produced intangible assets:

(i) it does not elaborate on the scope and conceptual nature of purchased goodwill and other intangible non-produced assets, or why they are economic assets to be included in the system;

(ii) the calculation of purchased goodwill is different for unincorporated enterprises and corporations;

(iii) purchased goodwill is only recognised when a business is purchased, but goodwill is likely to be present in all businesses; and

(iv) it does not elaborate on why they should be classified as non-produced assets and how they should be amortised.

Discussion of the issues

Clarification on the nature of the assets

13. 1993 SNA provides a description of how purchased goodwill is derived without elaborating on the economic nature of the asset. The relevant references are paragraphs 12.22, 12.23 and the Annex - Definition of Assets. The latter describes purchased goodwill as:

'The difference between the value paid for an enterprise as a going concern and the sum of its assets less the sum of its liabilities, each item of which has been separately identified and valued' (1993 SNA Annex - Definition of assets, p.310).

14. As an accounting entry in SNA, purchased goodwill is a mechanism to align the value of assets and liabilities of a business with the demonstrated market value of that business at point of sale. It is a 'residual' value that ensures that the value of a business's assets less its liabilities is equal to the value of shares and other equity that changes hands in the sale. When a business is sold, purchased goodwill is recorded in the other changes in volume of assets account of the seller as an economic appearance of a non-produced asset. It is also shown concurrently as a disposal of a non-produced asset in the capital account of the seller and an acquisition of a non-produced asset in the capital account of the purchaser. The sales and purchases of shares and other equity associated with the sale of the business are shown in the financial accounts of the buyer and seller.

15. As an economic asset goodwill should be described as the 'going concern' value of a business, reflecting the value of corporate structures and the value to the business of an assembled workforce and management, corporate culture, distribution networks and customer base. It may not have value in isolation from other assets, but it enhances the value of those other assets. Looked at another way, it is the addition to the value of individual assets because they are used in combination with each other.

16. Goodwill cannot be separately identified and sold to another party. It exists in combination with the identified assets of a business and can only be derived residually by deducting the value of the identified assets from the value of the net assets of the whole business. In SNA terms, it has to be derived by deducting from the sale value the value of assets and liabilities classified elsewhere within the SNA asset boundary. In practice, purchased goodwill will also reflect errors and omissions in the valuation of other assets and liabilities as it is calculated as a residual.

17. Potential purchasers of a business will be prepared to pay a premium above the value of individually identified and valued assets and liabilities for the going concern value of a business and the synergies available from combining with other businesses. It could also be expected that the share market will factor in this going concern value even when a business is not the subject of a sale.

18. Goodwill yields capital services to the process of production and, accordingly, businesses will expect a return on the goodwill asset which is reflected ex post in gross operating surplus.

19. Goodwill is only recognised in the System when a business is sold and hence the term 'purchased goodwill'. It needs to be acknowledged that a goodwill asset is likely to be present in most businesses, but for reasons of reliability of measurement it only enters the system when its value is evidenced by a market transaction. See further discussion on this below.

20. **The Canberra II Group recommends that the nature of purchased goodwill be clarified in 1993 SNA along the lines described above.**

21. Brand names, mastheads, trademarks, logos and domain names are hereafter referred to as 'marketing assets'. A brand can be interpreted as far more than just a corporate name or logo. It is the overall impression a customer or potential customer gains from their experience with the company and its products. Interpreted in that wider sense it can also be seen to encompass some of the characteristics of goodwill such as customer loyalty. Without customers, the capital services generated by the other assets are not realised in the market.

22. Unlike goodwill assets, marketing assets are identifiable as separate assets, and can be sold or licensed (franchised) to others. However, international accounting standards prohibit the recognition of internally generated brands, mastheads and items similar in substance, except when they are evidenced by a transaction in the assets or by the sale of a business (see below).

23. As with goodwill, marketing assets provide capital services to production. They provide the connection between the product and the customer and the owners of a desirable brand can expect a return on the value of the brand to be reflected in their operating surplus.

24. **Although marketing assets are normally identifiable as separate assets from goodwill, the Canberra II Group recommends they be included in the same asset category as purchased goodwill. In the main, the value of marketing assets would only be available when a business is sold, and even then they could be bundled with goodwill. When a separate transaction does occur, it should be recorded.**

25. The recommended treatment of purchased goodwill and marketing assets is consistent with International Financial Reporting Standard 3 - Business Combinations and International Accounting Standard 38 - Intangible Assets (both issued by the International Accounting Standards Board in March 2004). IFRS 3 describes goodwill as 'the excess of the cost of the business combination over the acquirer's interest in the fair value of the identifiable assets, liabilities and contingent liabilities ...' (para 51). Regarding ‘identifiable’ assets that are recorded separately from goodwill, it goes on to say that the acquirer recognizes separately an intangible asset only if it is capable of being separated from the entity and it can be reliably valued. Marketing assets are generally separable, but there are issues as to whether they can be reliably valued, especially where there is no evidence of transactions in the same or similar assets to base their value. As previously mentioned, IAS 38 prohibits the recognition of internally generated brands and the like unless they have been the subject of a market transaction (para 63).

26. Goodwill in business accounts could have some significant differences in scope and valuation to that required in the SNA. Any differences between business accounting and the SNA in the recognition or valuation of assets and liabilities will impact on the residual asset value derived by reference to the sale value of a business. For example, there are a number of assets included in the SNA asset boundary that will only be recognised in business accounts in very restrictive circumstances. These include internally generated produced assets such as software, databases, entertainment, literary or artistic originals and potentially, research and development. If they are not separately identified and valued in a

business sale, the goodwill value obtained from business sources would have to be adjusted to avoid double counting on the SNA balance sheet.

Consistency in application

27. In the 1993 SNA, purchased goodwill is calculated differently depending on whether the business is an unincorporated enterprises or a corporation. For an unincorporated enterprise, purchased goodwill is derived as the difference between its separately identified and valued assets and liabilities and the sale price. For corporations it is described as the difference between the share price immediately before the sale and the actual sale price per share, multiplied by the number of shares (para.12.22).

28. It does not make any distinction between listed and unlisted companies in the calculation of purchased goodwill. For the latter, it would presumably have to be calculated according to the procedure outlined for unincorporated enterprises i.e. the excess of the purchase price over its identified assets and liabilities.

29. The description of the calculation of purchased goodwill for unincorporated enterprises is entirely consistent with the notion of goodwill in national accounting and business accounting as the value of assets less liabilities that are not separately recognised and measured. The rationale for the treatment adopted for corporations remains unclear. It seems to imply that the market only factors in the value of the goodwill asset just before the sale of a business. While this may be true of the value of expected synergies from business combination, it is unlikely to be true of other aspects of goodwill.

30. **The Canberra II Group recommends that purchased goodwill and marketing assets should be calculated as the excess of the purchase (or takeover) value of a business over the value of the other assets and liabilities otherwise identified in the SNA system for that business. The same calculation should apply for both unincorporated businesses (including quasi corporations) and all incorporated businesses.**

31. One further point of clarification is required. In 1993 SNA, shares and other equity (F.5) are treated as a liability of a corporation to its shareholders. As purchased goodwill is used to balance assets less liabilities with the sale value of shares and other equity, it follows that, at the time of sale, the net worth of a corporation is zero by definition. 1993 SNA already defines the net worth of quasi corporations to be zero at any point in time because the value of owners' equity is assumed to be equal to its assets less its liabilities (para 13.83). Given the logic of the previous paragraph it would appear that zero net worth was also the intention for corporations at the point of sale, although this is not explicitly stated.

Internally generated assets not evidenced by a market transaction

32. Internally generated goodwill and marketing assets will be present in most businesses, regardless of whether they are evidenced by a business sale. However, internally generated goodwill is excluded from the asset boundary of 1993 SNA. This is contrary to the treatment of internally generated produced intangible assets - computer software, mineral exploration and literary or artistic originals - which are all included within the asset boundary. Internally generated marketing assets are not explicitly excluded from the asset boundary, although in practice it is likely that they would only have been included when their value was evidenced by a market transaction or as part of purchased goodwill.

33. Canberra II Group considered whether the same residual estimation approach that is applied when a business is sold should be applied at any point in time by using the current capitalised market value of shares and other equity as the current market value of the businesses. As already mentioned, this value

is already calculated within the system as 'shares and other equity' and is recorded as a liability of the corporations sectors to the sectors owning the equity (ultimately householders, general government and rest of the world).

34. If such an approach were to be adopted, the net worth of the corporations sectors in SNA would always be zero because the value of a business's assets less its liabilities would be set equal to the value of shares and other equity issued. Internally generated goodwill would be the residual that achieves this balance.

35. Related to this is the clarification of valuation and symmetry concepts in SNA between the value of assets less liabilities and the market value of shares and other equity. The 1993 SNA states that corporations (but not quasi-corporations) have a net worth that can be positive or negative (para 13.83) implying that such symmetry does not have to hold.

36. Canberra II Group does not support the use of capitalised share market values to calculate internally generated goodwill, except where evidenced by a sale of a business. This is for the following reasons:

(i) share markets are volatile and can over or undershoot the value of a corporation's net assets, especially during boom and bust periods.

(ii) share markets prices represent marginal prices which may be different from the price if all shares in an enterprise were offered for sale (or the price required to achieve a takeover)

(iii) due diligence is only undertaken at the time a business is offered for sale or is the subject of a takeover, and

(iv) there is no current market value for unquoted shares, except on sale of a business.

37. **Canberra II Group recommends that internally generated goodwill and marketing assets should be excluded except where they are evidenced by a sale. It also reaffirmed that in any one accounting period there is no reason for the sum of all recorded and unrecorded assets less liabilities of corporations to be exactly equal to the value of shares and other equity held by the owners (and recorded as a liability in the corporation sectors' balance sheet). However, given rational markets it could be expected to show reasonable correspondence over the medium term. This should be made explicit in SNA.**

38. As previously described, net worth for all enterprises will be zero at the point of sale. For unincorporated enterprises and quasi-corporations it will also be zero at any other point in time. Otherwise, depending on how the value of unquoted shares and other equity is calculated, net worth for unlisted corporations could be a positive or negative value. For listed corporations, net worth could be a positive or negative value except at the time of sale.

39. A non-zero value for net worth represents any discrepancy between the actual value of identified assets less liabilities of corporations and the share market valuation of those corporations at the end of the accounting period. It could be composed of internally generated goodwill and marketing assets, any under or overshoot in the share market valuation and/or errors and omissions in the valuation of assets and liabilities identified elsewhere in 1993 SNA. This latter component could be significant, so in practice net worth for the corporations sectors may be interpreted as being largely composed of errors and omissions in the valuation of other assets and liabilities in SNA.

Produced or non-produced assets?

40. The existing treatment of purchased goodwill and marketing assets as non-produced assets is consistent with their 'sudden' appearance when an enterprise is sold. However, Canberra II Group were of the view that major elements of purchased goodwill and marketing assets are in fact produced, but difficulties involved in identifying the expenditures that might be treated as gross fixed capital formation are too great to enable a reclassification to produced assets.

41. A number of the Canberra II Group members were attracted to exploring the idea that marketing assets could be measured by treating certain advertising costs as gross fixed capital formation, but were unwilling to support such an extension to the produced asset boundary at this time. The approach rests on the premise that certain marketing expenditures are an investment that generates future income rather than being a cost of deriving current income. Valuable brands do not just 'appear'. Marketing is a key driver of brand value and big corporations invest heavily in building and supporting their brands by advertising, sponsorship and other measures to build a positive image with customers. However, a difficulty to be resolved is the identification of brand building expenditures as distinct from maintenance of an existing brand asset and other advertising expenditures that are in the nature of current operating costs.

42. Although there was no support for reclassifying purchased goodwill and marketing assets as produced assets, members remained somewhat uneasy about describing them as non-produced. Further thought will be given to whether a more appropriate terminology or other form of description can be used in the context of the asset classification.

43. **Canberra II Group recommends that purchased goodwill and marketing assets continue to be treated as 'non-produced' assets in SNA. However, further consideration will be given to whether a terminology can be found that better reflects the nature of these assets.**

Amortisation

44. 1993 SNA paragraph 12.34 states:

> "Just as the appearance of intangible non-produced assets is recorded in the other change in the volume of assets account, so is their write-off, termination or exhaustion. For purchased goodwill, amortisation should be recorded over a period of time after the purchase of an enterprise, following country accounting standards ...."

45. Purchased goodwill and marketing assets are not subject to wear and tear like physical assets. Once established at the point of sale they can be maintained indefinitely, enhanced or run down depending on a business's efforts to maintain or improve its good reputation with customers and its efficient business structures. As such, it is not appropriate to simply write the assets off over time at a predetermined rate.

46. IFRS 3- Business Combinations prohibits the amortisation of goodwill:

"Goodwill acquired in a business combination shall not be amortised. Instead, the acquirer shall test it for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired ..." (paragraph 55)

47. Where there has been no impairment, the acquired value of goodwill can remain on the balance sheet indefinitely. A similar treatment is prescribed for other intangible assets with indefinite useful lives, such as marketing assets. Where marketing assets are identified separately and have a definite life

(e.g. where future benefits are established under legal rights for a specified period) they are amortised over their useful life.

48. The treatment under the international accounting standards would also appear an appropriate treatment in the SNA. When an asset is impaired, the write-down during the accounting period is recorded as an ‘other economic disappearance of a non-produced asset’ in the other changes in volume of assets account. However, there are some complications in the SNA recording where a business is already carrying purchased goodwill and marketing assets on its balance sheet when it is sold. Remaining goodwill and marketing assets of the seller would have to be written off as an other economic disappearance of a non-produced asset at the point of sale. It would be immediately recalculated and reappears on the balance sheet of the purchaser as an 'other economic appearance of non-produced assets'. In practice, only the net of appearances less disappearances are likely to be recorded (it could be positive or negative).

49. Purchased goodwill and marketing assets could increase rather than decrease in value over time. This will not be captured in the business data because the assets are valued at acquisition cost less any impairment write-downs. In principle, a general price escalation factor should be applied to the source data to derive the values to be recorded in the SNA. This would be particularly important during periods of high inflation.

50. **The Canberra II Group recommends that the 1993 SNA discussion of the amortisation of purchased goodwill and marketing assets be changed to reflect the impairment approach adopted in the international accounting standards.**

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Points for discussion:

1. Do you agree that an asset class 'Purchased goodwill and marketing assets' should replace the existing 'purchased goodwill'?

2. Do you agree that the economic nature of purchased goodwill and marketing assets should be clarified along the lines presented in this paper?

3. Do you agree that the valuation principles for purchased goodwill and marketing assets should be applied consistently, irrespective of whether the entity is a listed or unlisted corporation, a quasi corporation or is unincorporated. They should be calculated as the excess of the purchase (or takeover) value of a business over the value of the other assets and liabilities otherwise identified in the SNA system for that business?

4. Do you agree that internally generated goodwill and marketing assets should continue to be excluded, except when their value is evidenced by a sale. In the case of internally generated goodwill, this occurs only with the sale of a business. In the case of marketing assets it can also occur with their independent sale?

5. Do you agree that the assets should continue to be classified as non-produced assets, even though their value is often driven by a productive activity. However, further consideration will be given by the Canberra II Group to whether a term can be found that better reflects the nature of these assets. This will be addressed in the issues paper concerning Classification and terminology of assets (Issue 27)?

6. Do you agree that the assets should not be amortised at a predetermined rate but made subject to an impairment test consistent with the international accounting standards for these assets?