Twitter Thread by Fincademy

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What is intangible asset? Why investors should focus on it?

1/ Well, everyone knows an Intangible asset is not physical in nature i.e., it is something that we cannot touch. Let explore more into the concept of intangible assets – a valuable driver for companies.

2/ Intangible assets include goodwill, brand value, patent, copyright, trademark, etc. It is important to evaluate these assets as they are a valuable contributor to a company for long-term success or failure. For instance, companies like Amazon, Apple, Google, Microsoft

3/ are successful due to significant brand recognition. Similarly, Indian FMCG companies like HUL, Coalgate, Britannia enjoy huge benefits due to investment in brand awareness. IT and Pharmaceutical companies protect their sales through patents, copyright, software licensing.

4/ Most internally created intangible assets are not recorded on the company's balance sheet or have no recorded book value. For instance, even though a coca-cola logo carries huge brand value, it does not show on the balance sheet because it was created internally, and

5/ does not have a price to assign fair market value. However, if company A purchases copyrights from company B, it will be recorded in the company 's A balance sheet as an intangible asset.

6/ There are certain exceptions and criteria, to recognize internally created intangible assets. Suppose the company incurred any cost in the development phase to create a patent is generally capitalized as an expense. We will discuss this example later in the thread.

7/ Goodwill and Intangible assets are used interchangeably but there is a significant difference between the two in accounting terms. The two terms are listed in separate line items on the balance sheet.

8/ Goodwill is a type of intangible asset which is recorded on the balance sheet when a company completes an acquisition with another company for premium value. It accounts for all non-quantifiable items such as brand recognition, strong customer base. The process of calculating

9/ goodwill is simple in theory but complex to measure when put into practice. A simple way to define goodwill is to subtract the purchase price from the market value of a net asset of the acquire.

Goodwill = Purchase price of the target company - (MV Asset – MV liabilities)

10/ Let us consider the example of the T-Mobile & Sprint Merger in 2018. The deal was valued at $35.8 billion in March 2018. The net value of the asset comes around $32.4 B. Thus, the premium paid for the deal was $3.4 Billion and is recognized as Goodwill in T-Mobile's b/sheet.

11/ Anything a firm pays above the fair market value of its net assets is identifiable as goodwill. Microsoft bought LinkedIn at $25B, though the net asset value of LinkedIn was $4 B. Microsoft paid a whopping premium of $21 B for LinkedIn brand, customer base, technology.

12/ Whereas intangible assets which are not physical but identifiable such as patent, copyrights, licensing contract, website domain name, blueprints, etc. It is possible for a company to estimate the value of these assets and can be bought and sold independently unlike goodwill.

13/ So, now how do we justify something which is not physically existing on the balance sheet? Tangible assets with estimated life spans are expensed using depreciation. Similarly, amortization is used to reflect the reduction in the value of intangible assets with definite life.

14/ Lets us first understand how to make a distinction between internally created intangible and acquired intangible assets. Suppose the company spent ■10 lakh for developing software in-house, ■9 lakh legal fees to obtain the patent for 12 years, and ■20 lakh for promotion.

15/ How should a company account for this cost? So, ■10 lakh should be expensed as development expense, ■20 lakh is expensed as promotion cost, and ■9 lakh patent cost should be recorded as an intangible asset and amortized over its useful life of 12 years.

16/ So, each year the value of software (patent) is reduced by ■75000 (9,00,000/12) in the balance sheet using the straight-line method, and the same value is shown in the income statement under amortization expense.

17/ Likewise, if a company spent ■10 lakh on the purchase of a patent with a useful life of 5 years, ■2 lakhs is amortized each year using the straight-line method. According to International accounting standards, Goodwill with an indefinite life is not amortized rather

18/ value should be periodically reviewed with an impairment test. If a company acquired asset falls below the carrying value or book value, then it must be impaired or written down to its current value. And this expense is recognized as a loss in the income statement.

19/ How does asset impairment work? When the company records a goodwill impairment, it is signalling that the fair market value of the purchased asset has fallen compared to what the company paid to the acquired entity.

20/ For instance, in 2013-14, Microsoft acquired Nokia at approx. $7.9 B. and recognize $5.5B Goodwill related to acquisition. Later, Microsoft realized that the book value of goodwill was deemed to be overstated because the company was not able to capitalize the

21/ potential benefit in the cell phone business through the Nokia deal, and finally in 2016 company writes-off $7.2B of which approx. $ 5.1B was recorded as Goodwill impairment charges from the Nokia deal. There are various reasons for impairment includes

22/ weakening economic conditions, legal issues, increasing competition, changes in course of business. Though there is the complexity involved in calculating and evaluating impairments risk but there are few broad aspects which investor can examine while analyzing company

23/ such as evaluate company’s past acquisition, assess intangibles asset (Goodwill) to total asset ratio, focus on the company’s ROA when a large proportion of total asset is attributable to intangible asset. So, Intangible assets (and goodwill) reflect valuable information and

24/ are important drivers for shareholders' value, especially when a lot of leading companies are in technology (knowledge-based) and service industries. And assessing such companies requires effort to study these assets to uncover potential competitive advantage of business.

As you had understood everything related to intangible asset, we have also started our new venture, where you can learn more about finance and stock market, so check-out the link:-

WhatsApp : https://t.co/tMR5oBAjsX
Telegram : https://t.co/qzAJdsljMl

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