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# The Real Value of Intangibles

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Breakthrough Thoughts

# The Real Value of Intangibles

There is no accepted standard for appraising the worth of nonphysical assets like brands, human capital, and managerial expertise. Yet these are the essence of 21st-century business.

by Denise Caruso

When Google Inc. published its 2007 annual report, the assets listed on its financial statements did not include the value of the Google Network — the thousands of third-party Web sites that use Google's advertising programs to deliver ads to their sites, and from which the company derived nearly US$6 billion and 35 percent of its total revenues that year.

Nor did it include a value for Google's brand identity, ranked first in the world and valued at $66 billion in 2007 by market researcher Millward Brown Optimor, or for the company's *crème de la crème* workforce, whose freedom to experiment with new product ideas using company time and equipment has contributed demonstrably to the company's bottom line.

In fact, because of the often perverse effect of disclosure regulations, Google's annual report could publicly acknowledge these tremendous assets only through the looking glass, as potential liabilities. That is, in the standard "risk factors" section of the report, Google executives could say only that their partners, employees, brand, and reputation were of such great value that if they dropped the ball in any of these areas, their business would be adversely affected. That's a pretty twisted way to have to frame the assets that deliver more than one-third of your company's revenue.

When one considers the limits of the current approach to asset measurement and valuation, Google may look like an extreme case, but its situation is different only in scale from many other corporations that are also stuck with outdated accounting and reporting methods. The book value of today's global corporation is derived largely from procedures invented hundreds of years ago to record costs in transactions such as the buying or selling of grains, animals, buildings, machinery, and other tangible assets.

Although cost may help determine the value of physical assets, the same cannot be said for intangibles. These assets — intellectual property, software investments, staff and managerial expertise, market research, advertising, business processes, organizational structures,

Illustration by Lars Leetaru

and the like — are the real stuff of which 21st-century companies are made. Today, $100,000 can buy a patent that turns out to be worthless or an employee whose great idea tacks a million dollars onto the bottom line. As a result, traditional accounting practices that can record only what things cost, or their resale value, are hopelessly inadequate in representing intangible assets.

In fact, based on the difference between reported book and stock values, intangible assets now make up between 60 and 80 percent of global corporate worth. The monetary value represented by those percentages is staggering. Leonard Nakamura of the Philadelphia Federal Reserve Bank declared in 2001 that the value of gross investments in such intangibles as alliances and networks, human capital, and leadership was greater than $1 trillion annually for the United States alone. Reports from both the Federal Reserve and the National Bureau of Economic Research (NBER) calculated that as much as $800 billion of intangible investment was excluded from published data on U.S. gross domestic product in 2003. The exclusion translated to more than $3 trillion of intangible corporate value. When the authors of the NBER working paper — Carol Corrado, Charles Hulten, and Daniel Sichel — added intangible assets to the sources-of-growth framework used by the Bureau of Labor Statistics, they saw "a significant difference in the observed patterns of U.S. economic growth" that drive investment, corporate strategy, and government market interventions.

What a remarkable statement! Even more remarkable is that the statement did not set off a firestorm in the financial press or trigger an immediate demand for reform from the business community. If the absence of effective accounting for intangibles is significantly skewing official statistics, that means the daily decisions being made by investors, managers, and regulators are actually based on financial data that has only a marginal connection with economic reality — and does not even acknowledge the existence of the most important drivers of value in the global economy.

No wonder all the buzz these days is about the "irrationality" of markets. Fed a constant stream of misinformation, how rationally could they behave?

### The Evolution of Goodwill

Although intangibles are not exiled from the balance sheet altogether, where and how they do show up is testimony to the nature of the problem. In conventional accounting, intellectual capital and other intangibles appear on a company's balance sheet only in the course of an acquisition, as "goodwill" — the lump-sum difference between the amount a buyer paid to acquire another company and the book value of the acquired firm or its acquired shares. This amount generally represents the value that a company has accrued by way of its brand, reputation, customer service, and other nonphysical assets.

Until 2001, in the U.S. the acquiring firm was required under generally accepted accounting principles (GAAP) to amortize goodwill in subsequent years as an expense. Then, in a halfhearted and barely perceptible nod to the importance of intangible assets, the Financial Accounting Standards Board (FASB) stopped requiring companies to

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amortize goodwill as a lump sum. Some intangibles with a definite useful lifespan, such as a patent, may still be amortized. Those with an indefinite useful life, such as a trade secret, can't be amortized, but are subject to an impairment test. That means that companies must record losses, such as a decline in brand value after a product recall. Other intangibles — for example, the value of an acquired workforce — are explicitly not included. This 2001 improvement in M&A accounting rules ignores the much larger issue: how to account for intangible assets that are created organically by and within an organization, not those that are acquired.

Two years later, in 2003, the Securities and Exchange Commission (SEC) established new guidance for Management's Discussion and Analysis (MD&A) statements. MD&A statements address the disclosure of nonfinancial performance measures that are material to a company's financial health. The SEC didn't use the word specifically, but some of these measures include intangibles, such as patents, technical licensing arrangements, and customer–vendor relations. Companies are now allowed to detail the number of patents in their portfolios — along with generally accepted industry performance measures, such as the number of citations by other patent applications or the cash flow from royalties. But they are barred from discussion of valuation or depreciation of those assets. The practical result, as in the case of the Google Network, is that investors are left to infer value from how the assets are disclosed.

What's more, although such measures at least give companies the option to disclose some of their intangible assets, the lack of clarity regarding intangibles opens the concept of materiality itself to debate — defeating the original intention of disclosure and reporting. For example, both the FASB and the American Institute of Certified Public Accountants (AICPA) developed lengthy lists of intangibles, but the two lists barely resembled each other. The FASB list, which replaced AICPA's, breaks intangibles into categories, such as "marketing-related" and "contract-based," whereas AICPA's list was more specific, including items such as "airport gates and slots" and "non-compete covenants."

## Marketing mechanisms are starting to emerge, and pricing mechanisms, comparability, and better valuations will follow.

Lists notwithstanding, neither accounting bodies nor regulators offer official definitions for intangible assets, individually or as a class. For example, under what circumstance does the money spent on an activity like research and development count as an intangible asset rather than an expense? When is technology classified as an asset rather than as a capability? Which intangibles should go on the balance sheet, and which can simply be disclosed? What constitutes effective disclosure? These innate ambiguities, coupled with the contentious nature of the problem, have kept official accounting bodies and financial regulators from fully engaging in solving the intangibles problem.

Some experts believe even half measures like the FASB's and the SEC's are a step in the right direction. But the risk of such half measures is that they can be perceived as an acceptable solution, when in fact they only obfuscate the issue.

### Valuing an Intangible

In 2004, the Economist Intelligence Unit conducted a survey of senior managers on intangibles. A whopping 94 percent of respondents said that managing intangible assets or intellectual capital is important. More than one-third ranked it as one of the top three management issues. In fact, nearly half of the respondents said they considered intangibles to be the primary source of long-term shareholder wealth creation for their companies.

But when asked about the systems they used to measure the performance of this important class of assets, 95 percent of the executives surveyed said they did not have such a system in place. "They know it's important. But if they don't have to disclose it, they don't measure it internally either," says Kenan Patrick Jarboe, executive director of the nonprofit Athena Alliance in Washington, which publishes reports on intangible assets and other aspects of the global economy. "I'm just waiting for somebody to get sued under Sarbanes-Oxley because they didn't disclose that 80 percent of their patents are worthless."

Even if disclosure issues were addressed, the valuation process itself is far from obvious. "Putting a number on intangibles is the difficult part," says Jarboe. "This is partly because these things get bundled together. We can put a value on a patent, but how much of that value can I pull out and say, 'The metal that makes up this six-axis remotely programmable lathe is worth $20, but the knowledge required to make it is worth $2,000'? It's hard to separate them."

If today's accounting rules don't work for intangibles, what valuation methods do work? According to Jarboe, any credible rating tool for intangibles must have three components. The first, and most critical, is transparency. "The process itself has to be transparent, and the assumptions you make in order to come up with the value have to be transparent," he says. Second is a clear definition. "Separability is important," he says. "If you say your entire corporate culture is an intangible asset, what does that mean? It has to be definable to differentiate it from other assets."

Finally, a good rating tool has to quantify the value of intangible assets. "This is the trickier part — some intangibles can be quantified a lot easier than others, and the quantifiability of some of them is changing," Jarboe says. For example, there has always been a market for patents, but it has traditionally been a "craft-like" market — more art than science, and certainly offering nothing like the comparability that determines prices in, say, the housing market. Without a central clearinghouse like those for houses or stocks, a place where sellers can go to list a patent for sale, it's a world of "one-off deals, a hunter–gatherer market," as Jarboe puts it. But market mechanisms, like patent clearinghouses, are starting to emerge; once they do, pricing mechanisms, comparability, and better valuations will follow.

More than a dozen approaches have been developed to measure and report intangible assets. But according to a 2005 report on intangibles by Rob McLean for the Value Measurement and Reporting Collaborative, a multinational organization of accounting bodies, the results derived from one approach have virtually nothing in common with results from another. Some models, including the balanced scorecard framework, link intangibles to performance by measuring key indicators, such as reductions in the cost of safety management or in customer complaints. Others use value drivers, such as sales growth or gross margins, or various "capitals" (such as human, intellectual, or social capital) to value intangibles. And although all approaches (except traditional accounting, of course) recognize the importance of broader context in setting a value, each has developed its own way for dealing with and representing that context. Such fundamental differences derail the potential for each approach to inform a broader economic conversation about intangible value. Nonetheless, the best of them seem to be tremendously useful to the companies that deploy them.

The Danish intellectual capital (IC) statement, for example, was first published in 2000 to help companies better communicate about their intangible assets. Three criteria — effects, activities, and resources — are used to evaluate the four knowledge resource categories (employees, customers, processes, and technologies) that are included in IC statements. This index has proven so critical to Danish businesses that, according to a November 2003 article by Per Nikolaj Bukh at the Aarhus School of Business, Mette Rosenkrands Johansen at the Aarhus School of Management, and Jan Mouritsen at the Copenhagen Business School, some companies use them as an alternative to the traditional annual report.

**Acknowledging the official value of intangibles can create open, fair, and efficient capital markets for them.**

But intangible assessments can be misused as well. The motive for deploying an assessment in the first place can be too slanted toward oversight, says Karl-Erik Sveiby, a professor of knowledge management at Hanken Business School in Helsinki, Finland. "Managers are primarily interested in the control aspect — productivity in particular," he says. "But intangible assessments should be a means of discovering hidden value." When they are focused on the bottom line with intangibles, Sveiby says, managers overlook a more critical issue: renewing or using them to innovate or reduce risk.

"Truth is, a lot of value creation goes on that is never translated into financial terms — it just happens," Sveiby says. He points to one Norwegian hospital where the nurses had asked what they could do to reduce the fear in patients going in for surgery. "They [decided to] invite ex-patients to talk to the new patients over coffee and cake," says Sveiby. "It was a huge success." A knowledge manager on staff who had been trained in Sveiby's Intellectual Assets Monitor approach wanted to know how the nurses and doctors knew the fear had diminished. The nurses answered that the new patients were asking fewer questions. "This meant that the doctors and nurses saved time, which of course is money," says Sveiby.

But where was the intangible value created? By one measure, the "customers" (patients) created it themselves. By another measure, the starting point was a successful surgery for ex-patients to discuss, so the value was due to the skill of the surgeons. Or perhaps the value was realized only because clever nurses invented the project.

How then should the hospital use that information? Should it redeploy the saved time to schedule more surgeries, which bring in more revenue? Should it "cash out" the time saved and apply it to offset general overhead? Or should it allocate it to higher salaries to hold on to its dedicated and innovative nursing staff? Most intangible assets will always defy valuation in the book sense.

To truly value intangible assets, a complex process is required, involving an enormous strategic investment and a lot of work. Why would anyone bother? Because acknowledging the real value of intangibles can create open, fair, and efficient capital markets for some of these assets. As noted earlier, businesses are losing access to as much as $3 trillion a year in capital stock by leaving intangibles out of the value equation. This directly affects the ability of individual companies to compete, to innovate, and to invest.

**In Search of a Method**

In addition to Denmark, other countries in the Nordic region are moving forward on efforts to improve business performance by actively addressing intangibles in both internal strategies and communications with shareholders. There has also been progress in India and Spain. And in Japan, many large organizations, such as Hitachi Ltd., publish intangible ratings in their annual reports and use them internally to improve performance. The Japanese government has also become involved. The Ministry of Economy, Trade, and Industry distributes white papers and measurement tools for intangibles, openly endorsing their use.

But in the U.S., where the issue briefly caught the attention of several government and finance organizations at the beginning of the decade, efforts to address intangibles not associated with acquisitions have petered out. "They talk about needing to move to more future-oriented indicators, but no one is looking specifically at intangibles," says Ken Jarboe. As Karl-Erik Sveiby puts it, "The U.S. has zero interest in this — and I mean 0.0."

One explanation for this attitude is that executives don't believe the risk of disclosure is worth the benefit. "When you ask companies to disclose this information, they immediately say, 'Why should we give away proprietary information? This is competitive advantage.' Of course, companies have been saying that for centuries about everything," says Jarboe. And the flip side is that companies may not want to reveal their competitive *dis*advantage. Who wants to disclose a worthless patent portfolio?

Shareholder liability issues make U.S. companies even more squeamish. Because lawyers representing shareholders can work on contingency and have been known to troll for companies to sue, public firms will often disclose only what they absolutely must. Most experts on intangibles agree that liability issues are stopping even companies that would like to disclose their intangible assets from doing so. As the Value Measurement and Reporting Collaborative's Rob McLean says, "The only way a new approach can work is by safe-harbor legislation. Companies that put forth their vision of the future by valuing their intangibles should not get sued when — surprise, surprise — life doesn't happen exactly as they modeled it."

It would be naive to overlook the role that today's "objective" and "factual" financial statements played in recent corporate scandals. In reality, financial statements are often the worst kind of fiction — the kind that pretends to be truth. Books are legally cooked with regularity as numbers are shuffled and accounts are juggled to put the best possible face on quarterly earnings reports or to present an acquisition in the most flattering light.

Whether companies' reasons for avoiding the intangibles issue are valid or not, they may not be able to bar the door from disclosure much longer. In part that's because investors are exerting increasing pressure on executives to provide them with performance indicators for these assets. Thus it is to no one's advantage for there to be a lack of reporting standards or audits for intangibles and for disclosure to remain voluntary. No matter what the state of a company's intangible asset portfolio, its reputation is likely to take just as hard a hit for withholding disclosure once its competitors have laid their own intangibles on the table.

But it's time to stop looking to the accounting profession for the leadership required to deal sensibly with intangibles. As distasteful as the suggestion might be in a corporate climate, where any government intervention or regulation is suspect, it is likely that the only way to ensure that intangible assets are represented fairly and accurately is for government to play an active role in the process. And it seems likely that that change will come from those who study the economy at large and work down into the ranks of individual financial officers. "Macroeconomists are the ones who are going to make the change," Jarboe declares. "GAAP is the last thing the sell-side analysts look at anyhow. They know better. They know that corporate financials are either faulty or, if not a deliberate exercise in 'earnings management,' that they're incomplete without intangibles anyway."

In April 2007, the Bureau of Economic Analysis (BEA), which produces GDP data for the United States, announced that it was looking into intangibles as well as "the broader world of innovation." The BEA has been acquainting itself with such issues for some time now; it has designed a set of research and development satellite accounts to supplement the GDP accounts. It is also shifting R&D from an expense to an investment for accounting purposes.

This is not to say that government should try to make these massive changes on its own. But in active collaboration with all stakeholders and interested parties — including corporate executives, institutional investors, banks, statisticians, and setters of accounting standards — agencies like the BEA must take the lead in defining and implementing the standards that would grant intangible assets the status they deserve. In the process, they would return some credibility to both U.S. economic data and, eventually, to the financial statements of U.S. corporations.

A first step in that direction may have just taken place. In June 2008, the National Academies' Board on Science, Technology, and Economic Policy; the Committee on National Statistics; and the BEA convened a public meeting to discuss intangibles. Its agenda included what government statistical agencies are doing to gather data on intangibles and what government's role should be in supporting markets and promoting investment in intangibles. With the right people and organizations in attendance and a rallying of political and institutional will, the gathering may have breathed new life into this languishing but critically important issue. +

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