

Those slippery intangibles

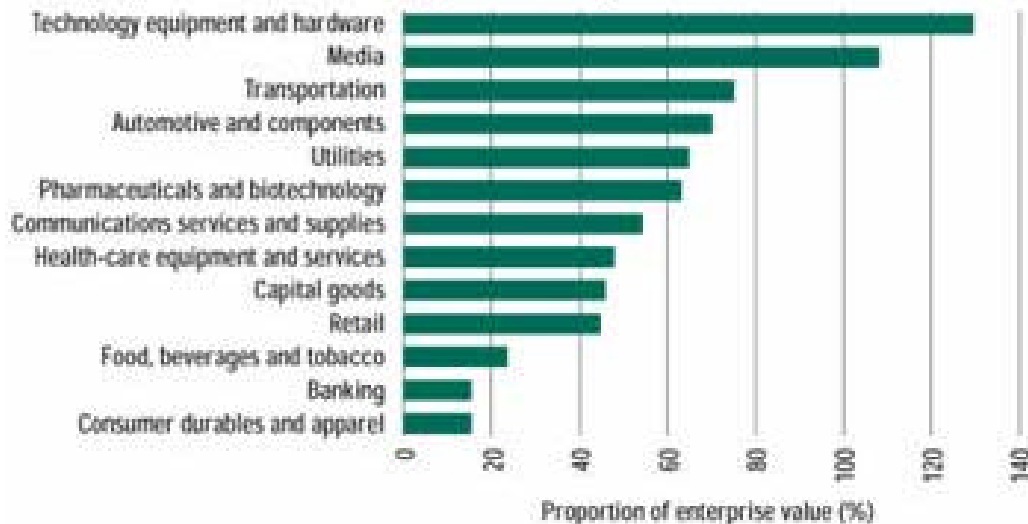
How a business performs is not solely dependent on black and white issues.

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FUTURE SHOCK

Industry-specific future value as a proportion of enterprise value



SOURCE: ACCENTURE ANALYSIS / RUSSELL 3000 INDEX

The contemporary manager has a problem. It is no longer possible to touch or see the things that matter to business performance. A long-term shift from tangibles to intangibles is occurring in many industries. The focus is no longer mainly on cash, inventory, plant and equipment or land, which typically accounts for only about one-fifth of a firm's value.

Instead, more slippery considerations such as vision, motivation, various types of explicit and implicit knowledge, customer and employee loyalty, and brands are the key determinants of an enterprise's performance. In 1982, 60% of the value of the United States S&P 500 companies was accounted for by tangibles. By 1999, it had fallen to 16% (the figure remains below 20%). According to the consultancy firms Accenture and AssetEconomics, by mid-2003, \$US7.6 trillion, or 58% of the value of the US stockmarket, was a valuation of the future potential of intangibles.

A 2003 survey by Accenture, AssetEconomics and the Economist Intelligence Unit of American companies found that half the executives listed the management of intangibles as one of their top three priorities. Yet only 5% said they had a robust system of measurement. One-third had no measurement in place, and 61% had measures that were either informal or unorganised.

John Barton, principal of John Barton Associates, says companies have trouble developing the new ways of thinking required to understand and assess intangible assets. "What you see in company after company is that knowledge management is pushed back into IT."

The picture in Australia's oligopolistic market is less dramatic, but tangible assets still represent a declining share of a company's prominent value. Among the big banks, for example, net tangible assets per share represent only about one-third of the value of the shares (23% in the case of St George Bank). Net tangible assets equate with only a quarter of the share price of Coles Myer and only 7% of Woolworths' value.

Woolworths' \$2.75 bid for Australian Leisure and Hospitality Group (ALH) puts the net tangible assets of its takeover target at only 1.8% of the share price. Although such figures do not precisely reveal the residual value of intangible assets (share prices also reflect increases in the value of tangible assets), they do indicate that in many big Australian companies at least half the value resides in intangibles.

Yet observing recent accounting "reforms", one could be forgiven for thinking the opposite was true. With the introduction of CLERP 9, accounting practice has leaned more towards playing down the valuations of intangibles and to impose on them aggressive depreciation regimes.

Resorting to the familiar

The so-called generally accepted accounting principles (GAAP) require that some identifiable intangibles that have been acquired from other entities be reported, but do not require intangibles that have been developed in-house to be reported. This has the distinct appearance of accountants resorting to the familiar because it is easy.

The commercial shift from tangibles to intangibles in the past 20 years suggests it would make more sense to be aggressive in downgrading tangible assets. In the car industry, for example, where there has been a long-term shift to outsourcing production, it makes far more sense to downgrade tangibles such as plant and equipment than it does to depreciate brands, which are becoming a car company's primary asset. Present sentiment, nevertheless, points in the opposite direction.

The excesses of the dot-com boom, when intangibles were routinely given ludicrous values in order to deceive investors, have made regulators and investors wary. Yet this orgy of mis-pricing was more important for exposing the shortcomings of conventional valuation techniques than it was for showing that the importance of intangibles is exaggerated. Investors would have spotted the excesses more easily if there had been more convincing valuation methods available.

The management-consultancy community, ever alert to new fee-earning possibilities, is attempting to find ways to value intangible assets, such as "human capital". The signs are not promising.

What is required is not a modification of the methods used to value tangibles but a radical departure. Intangible assets are considered to be elements such as innovation, knowledge (explicit and tacit), governance, organisational design, reputation, customer and employee loyalty, capabilities and brand strength.

The way in which these are bought, sold and created, is different from tangible assets. For one thing, intangibles have a more uncertain value than is usually the case with tangible assets. Investing in knowledge generation, for instance, can lead nowhere or it can lead to high-value returns. The result of an investment in plant and equipment, by contrast, is comparatively predictable.

Some intangibles have completely different characteristics from tangibles. Knowledge, for instance, is usually not scarce in the way tangible assets are (because it is not lost to the owner when sold). Possessing knowledge is to some extent inevitable in a business, whereas owning a tangible asset is not.

It is hard to imagine a business without knowledge, at least if it is to have any hope of staying in existence. Businesses cannot "own" knowledge, except to the extent that they can legally protect its fruits through patents and brand names. The push from the accountancy community to take a pessimistic view of intangibles on the balance sheet is at least half right.

The "snapshot" approach to valuation (the balance sheet is a snapshot of a business's value at a moment in time) is not ideally suited to getting a grip on intangibles. What really matters is what income they will create, not what their resale value is (which means taking a close look at what customers will pay for in the future). For example, important staff members may create great value for an organisation, but they cannot be bought and sold in the way that, say, land can. Resale value is largely a meaningless measure for "human capital".

In many cases, it will be more appropriate to use methods analogous to net-present-value analysis (projecting future values and then discounting back to the present) than balance sheet valuations - an approach more like a stockbroking analyst's forecasts of future profits (see assessing intangibles, above). Although this will be hard to estimate in many cases, it is at least the right question: "What will our investment today in nurturing staff capabilities or customer loyalty or innovation mean to our revenue and profitability in five or 10 years' time?" This can be compared with likely costs during the same period, the payback period and probable returns.

Some intangibles, such as R&D, will tend to be subject to diminishing returns as discoveries are superseded - although in the US, studies have consistently shown that R&D has brought returns above 25%. Others, such as distinctive brands or unique organisational designs, may not have diminishing returns. To impose uniform depreciation standards is too crude. The push to let accountants be more aggressive in applying their existing methods will do little to help shareholders become more informed about the true value of businesses. Accountancy is a discipline that is heavily biased towards tangibles; it is not well suited to the newer worlds of commerce. "The dilemma for many accountants is that the goodwill factor has become larger than the rest of the balance sheet," Barton says.

The human factor

The greatest challenge is in human-resources management. The term itself inspires little confidence (humans are in no meaningful sense "resources"). Yet if intangibles are to be managed well, much depends on the way people are managed. All intangibles gain value only because of what people do.

Peter Aughton, chief executive of the consultancy Amerin and director of the Fred Emery Institute, says human-resource managers might do well to drop the title. "Human-resource managers often come through a background of the humanities, but somehow they lose their roots and try to run things as a machine. They get lost in bureaucracies and ... the reward structure."

Barton says what is required is "360-degree stakeholder management" - not just training workers to be multi-skilled, but also to involve them in management. Without this, the necessary innovation and flexibility will not materialise.

A recent positioning paper by the Australian Human Resources Institute and the Committee for Economic Development of Australia found that there are "shortcomings" in the training of HR managers, which tends to prevent them being involved in the strategy of the business.

"The art of the game is to link it together," Barton says. Managing intangibles requires greater intellectual flexibility - the ability to embrace different and less mechanistic ways of thinking about an enterprise - and rigorous action. Simply developing better measures will not be sufficient. "It only becomes meaningful if it is turned into action," he says.

Aughton says human-resources managers are not dealing well with the challenge. "HR managers have to determine what drives the intellectual capital, and have it ready for the annual general meeting. They are struggling with it. It should be the role of the HR manager to talk to the fund managers that invest heavily in these intangibles."

The longstanding tussle between formal accounting and management accounting seems to have swung in favor of the former at a time when it is least appropriate. This may represent an opportunity for the canny investor, but for managers it will often be best to treat the audit and accounting processes as distinct from the real business of creating wealth and keeping shareholders informed.

End

Assessing intangibles

One way to derive an assessment of intangibles is to use "future value analysis". According to an article by John J. Ballow, Robert J. Thomas and Goran Roos in the Journal of Applied Corporate Finance, this is the difference between a company's market capitalisation (the total value of its shares) and the "current value of daily operations".

The general rule of thumb, they say, is that capitalised current operating value equals 10 times the current earnings. Taking this approach to some of Australia's leading companies produces some interesting differences, as the table below shows.

For example, Coles Myer, which has far greater future value in its share price than its competitor Woolworths, also has a higher ratio of net tangible assets to its share price. This suggests that Woolworths is positioning itself to manage its intangibles more

aggressively than Coles Myer, yet Coles Myer is more reliant on the management of intangibles to justify its share price.

Patrick Corporation has a negative future value in its share price, compared with Toll Holdings, whose share price is 69.9%, based on future value. Yet the two companies have similar net tangible assets to share-price ratios, suggesting that Patrick could achieve much greater share price gains if it managed its intangibles well, whereas Toll must manage them well to justify its valuation.

Future value is only a tentative indication of a company's need to manage intangibles but, in combination with net tangible assets as a proportion of the share price, it does give an idea of a company's position.

Ballow, Thomas and Roos write that no US companies include accounting for intangibles in their annual reports. Only in Europe have there been serious attempts to improve the accounting for intangibles.

Relying on conventional accounting is almost certain to give a false picture. For example, conventional accounting recognises R&D only as an expense, which means it has a negative effect on earnings per share. Ballow, Thomas and Roos write: "Intangible assets behave differently [from] tangible assets, as anyone who has witnessed the overnight destruction of a brand will tell you. And because intangible assets and tangible assets have different characteristics, they must be managed differently. For example, intangible assets tend to be difficult to leverage in the short term; you can't get immediate value out of your brand the way you can by increasing the production rate of a piece of machinery. They also tend to be independent, so that their value depends on the industry and competitive context."

Table: [Where value lies: current daily operations against tangible assets](http://www.brw.com.au/pdf/20040722_b64.pdf) (PDF format – To access table go to http://www.brw.com.au/pdf/20040722_b64.pdf)