For what it's worth

Having communication channels other than traditional financial statements is critical for the financial wellbeing of companies rich in intangible assets

By **Terry Rooney** and **Nir Kossovsky**

"Companies built primarily on intangible assets are unfairly represented in an accounting system that cannot properly value them," opined *New York Times* business writer Denise Caruso recently. "More often than not, the most valuable assets of an innovative company – its intellectual property, investments in computer software, staff and managerial expertise, non-scientific and scientific research and development, advertising and market research, and business processes – have literally no place on the balance sheet."

In this article we explore the implications of this unfair representation of intangible asset value, its relationship to the economic concept of markets with asymmetric information and its impact on market liquidity and volatility.

Intangible assets

Intangible assets are those non-monetary assets that cannot be seen, touched or physically measured and which are created through time and/or effort. The Intangible Asset Finance Society divides them into four major market-centric groups. The first group comprises intellectual property rights such as trade secrets (eg, customer lists), copyrights, patents and trademarks. The other three groups comprise reputations for safety, security and resilience, and quality and integrity. These arise from knowledge activities (know-how, knowledge), collaboration activities, leverage activities and structural activities. Combined, these intangibles are the source from which competitive advantage flows or is destroyed.

Intangible asset book value

Common to all intangibles are the accounting rules that govern their balance sheet and profit and loss statement behaviour – rules that more likely than not lead to a misrepresentation of market value. There are several operating standards (Table 1), of which International Accounting Standard 38 is exemplary.

International Accounting Standard 38, promulgated in March 2004, requires an enterprise to recognise an intangible asset, whether purchased or self-created (at cost) if, and only if: it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and the cost of the asset can be measured reliably.

This requirement applies whether an intangible asset is acquired externally or generated internally. The probability of future economic benefits must be based on reasonable and supportable assumptions about conditions that will exist over the life of the asset. If an intangible item does not meet both the definition of and the criteria for recognition as an intangible asset, IAS 38 requires the expenditure on this item to be recognised as an expense when it is incurred.

Intangible asset market value

The capital markets ascribe market value to all assets – tangible and intangible alike. Because the constraints placed on the accountants that distort book value do not apply to the price discovery aspects of the capital markets, market values may deviate markedly from book value in intangible asset-rich companies. Estimates vary, but the consensus is that among the S&P 500 companies, intangible assets represent anywhere from 60% and 80% of the market

The Intangible Asset Finance Society comprises finance, innovation and intangible asset management professionals dedicated to capturing maximum value from intellectual properties and other intangible assets such as quality and integrity, safety, and security and resilience. IAM *magazine, a Globe White Page Ltd publication, is the media partner of the Society.* IAM *publishes in each issue a contribution from the Society on a noteworthy intangible asset finance matter.*

capitalisation – between 1.5x and 4x book value (Professor Baruch Lev of NYU's Stern School estimates the market to book ratio is often as high as 6) – and are therefore largely undervalued or not valued on the books. Intangible Business, an intangible asset valuation specialist, estimated that among the FTSE 100, the difference between the reported value of intangible assets and the market value of intangible assets was nearly £1,000 billion.

As noted recently by the Society in a letter to the *Economist*, much of the difficulty facing accountants in applying the rules to intangible asset value arises from the non-linear relationships among investment, value realisation and value loss. For example, Jet Blue Airways Corp (NASDAQ: JBLU) built a reputation for superior customer service with investments in staff training, marketing and advertising, as well as tangible aircraft amenities. It suffered a body blow to its customer service reputation and lost 40% of its market capitalisation on an icy weekend in February 2007 when its IT network, in which it had apparently under-invested, failed, stranding customers nationwide.

Value uncertainty and asymmetric markets

Corporate annual financial statements, and the quarterly updates supplemented by conferences with analysts, are the primary channels by which companies communicate their financial health and prospects to the investor community. Because corporate financial statements for companies rich in intangible assets do not disclose much about 60% to 80% of the companies' value, the securities markets may be operating with asymmetric information.

Asymmetries in information refer to variations across persons in the amount and quality of information about the characteristics of a company's security; or variations in the amount and quality of information between the generator of an externality and those affected. Information asymmetries in the markets impose trading costs and impair liquidity. They can result in a deterioration of market integrity and investor confidence. And periodically, as occurred in the mortgage bond market this past August, market failure results because individuals are basing economic decisions on incomplete or faulty information; and, therefore, are unable to participate in the market in a way that best serves their interests.

Studied by many, and important enough to be the centrepiece of the 2001 Nobel Prize in economics, asymmetric information is nevertheless a common feature of market interactions. For example, the seller of a good often knows more about its quality than the prospective buyer. The job applicant typically knows more about his ability than his potential employer. The buyer of an insurance policy usually knows more about her individual risk than the insurance company.

The premise for correcting the information asymmetry that can lead to market failure is straightforward: ensure all parties have the same level and quality of information on which to base decisions. In the United States, that role is played by the Securities and Exchange Commission. The SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use for judging whether to buy, sell or hold a particular security. To ensure that this objective is being met, the SEC continually works with all major market participants, including especially the investors in our securities markets, to listen to their concerns and to learn from their experience.

Communication channels other than traditional financial statements

Information is conventionally transmitted from firms to markets via five channels:

- Firms, in addition to mandatory disclosures, can disclose information to the public voluntarily (eg, earnings pre-announcements).
- Firms can selectively disclose information (eg, phone calls or one-on-one meetings).

Table 1. **Intangible asset accounting standards and duties**

Source	Designation	Year released
Financial Accounting Standards Board	SFAS 2	1974
Financial Accounting Standards Board	FAS 141, 142	2001
Sarbanes-Oxley Act of 2002 – Public Law 107-204	Sections 302, 404 and 409	2002
Financial Accounting Standards Board	Emerging Issues Task Force (EITF) Issue 02-17	2002
Securities and Exchange Commission	Guidance for the Management's Discussion and Analysis (MD&A) statement	2003
International Accounting Standards Board	IAS 36, 38	2004
International Financial Reporting Standard	IFRS 3	2004

Not always undervalued

On the books, intangible asset value is usually distorted, but not always undervalued. As noted in Michael F Price's introduction to Benjamin Graham's *The Interpretation of Financial Statements*:

> *"In the spring of 1975, shortly after I began my career at Mutual Shares Fund, Max Heine asked me to look at a small brewery – the F&M Schaefer Brewing Company. I'll never forget looking at the balance sheet and seeing a +/- $40 million net worth and $40 million in 'intangibles'. I said to Max, 'It looks cheap. It's trading for well below its net worth.... A classic value stock!' Max said, 'Look closer.'*
>
> *I looked in the notes and at the financial statements, but they didn't reveal where the intangibles figure came from. I called Schaefer's treasurer and said, 'I'm looking at your balance sheet. Tell me, what does the $40 million of intangibles relate to?' He replied, 'Don't you know our jingle, 'Schaefer is the one beer to have when you're having more than one.'?'*
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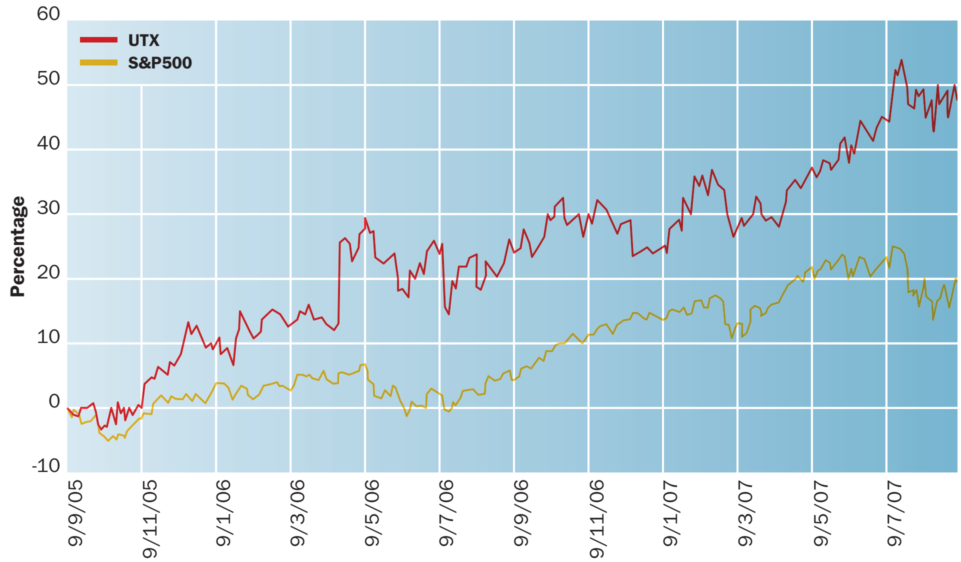
> *That was my first analysis of an intangible asset which, of course, was way overstated, increased book value, and showed higher earnings than were warranted in 1975. All this to keep Schaefer's stock price higher than it otherwise would have been. We didn't buy it."*

Figure 1: **Sleeper awakens**



United Technologies v S&P500 two year comparative returns illustrating the contributory value of communications. Transitioning into a superior intangible asset management strategy can create above average returns.

- Sell-side analysts can produce research which is released to the public (eg, analysts' reports).
- Private information can be produced by outsiders, informed traders, who then trade on the basis of their information.
- Enterprising journalists can break information/news.

In the United States, on the basis that selective disclosure promoted asymmetric information, Reg FD was promulgated. It was an implicit assumption that the same information would still flow into markets but by the other channels, particularly the first channel identified above. Yet all these channels rely on accounting standards (known as GAAP—Generally Accepted Accounting Principles); and, as the Athena Alliance noted succinctly, GAAP "… are unable to cope with intangibles".

The Intangible Asset Finance Society favours the P&L statement and market measures (eg, gross margins, net income, P/E multiple, price volatility) as both historic and forward indicators of intangible asset value. The Society concurs with Patrick Sullivan of the Gathering 2.0 that management's discussion and analysis (MD&A) of the value in qualitative terms helps investors form their own opinion on value. Moreover, the Society believes that rather than second-guessing the market value of intangibles, the concentration of effort by corporate management should be directed towards better intangible asset value management, communication and risk mitigation – and the market will then have the information it needs to discover price.

Communications at United Technologies

One company that appears to understand this communications goal is United Technologies (NYSE: UTX), a building systems and aerospace company. An enterprise rich in intangible assets, investor surveys showed that most viewed United Technologies "as some sleepy Northeast company", according to UTC Communications Vice-President Nancy T Lintner. So to communicate some of its intangible asset value – UTC's environmental responsibility, innovation and employee training – through channels other than traditional corporate financial statements, UTC launched an intangible asset advertising campaign.

For example, as reported in a recent article in *Business Week*, a print ad for the Sikorsky S-92 copter is: "Embedded with messages aimed at Wall Street. Text near the engine trumpets 40% lower maintenance costs than comparable helicopters and a 'health and usage system' that ensures the S-92 'always operates at peak performance'. The underlying theme: UTC is a great investment because it is a leader in innovation and eco-friendly technologies that help the bottom line." Other ads similar to the Sikorsky S-92 feature an Otis elevator, a Pratt & Whitney jet engine and a hybrid bus with United Technologies Power fuel cells.

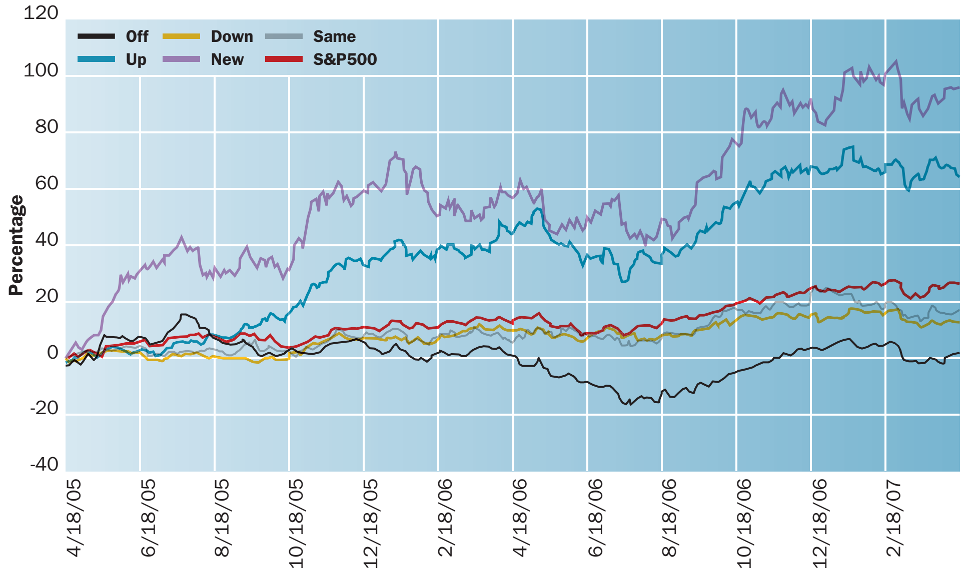
While promoting intangible asset value through channels other than traditional corporate financials is new for many companies, it has been the mainstay for companies in the fashion and fragrance industry. According to *Business Week*: "Fleishman-Hillard Eastern US President Peter J Verrengia thinks it's inevitable companies will one day manipulate their images with some of the same precision they use to optimize operating performance."

Value in intangible asset signaling

Intangible asset value communications is one aspect of superior intangible asset management. United Technologies' efforts in signaling intangible asset value through channels other than those traditionally used for financial information and their adoption of some of the principles of superior intangible asset management have helped their stock outperform the S&P500 materially over the past two years (Figure 1).

TOPCAP, an intangible asset management consultancy, reported previously that companies known to be superior intangible asset managers have a threefold higher market capitalisation than their revenue-matched peers. The United Technologies example and more recent data from Steel City Re, an enterprise value assurance company, show that there is a strong relationship between reputation – the manifestation of a company's intangible assets and the product, in part, of superior communications – and shareholder value appreciation (Figure 2).

Figure 2: **Recognition has its rewards**



Two-year returns for companies listed in the 2006 and 2007 *Fortune* magazine list of the top 20 most admired companies. Companies whose ranking dropped sufficiently from 2006 to knock them off the top 20 list in 2007 (Off) showed a spike in July 2005 but overall produced an average two-year return on investment of only 2% compared to an S&P 500® return of 27%. Firms that slid down in the top 20 rankings but still remained on the charts in 2007 (Down) showed a two-year average ROI of 13%. Companies that held their positions between 2006 and 2007 (Same) showed a two-year average ROI of 18%. Those that moved up in the top 20 rankings between 2006 and 2007 (Up) beat the S&P500 returns with a two-year average ROI of 64%. Those that were new to the top 20 most admired companies in the United States in 2007 (New), according to a *Fortune* magazine survey, showed a two-year average ROI of 95% (data courtesy of Steel City Re).

Failing systems

The United States, Europe and Japan are all principally intangible economies, but financial reporting and accounting systems can't deal with intangibles. The securities markets depend on the free flow of information to operate efficiently and are therefore hampered by the failures of traditional information tools that are based on the failing accounting systems.

The Intangible Asset Finance Society is dedicated to capturing maximum value from intellectual properties and other intangible assets such as quality, safety, security and brand equity. The Society's IA Value Signalling Committee is exploring best practices for communicating intangible asset value through channels other than conventional financial reporting. The evidence suggests that communications efforts by United Technologies are effective in helping to create shareholder value and are exemplary of the types of practice under consideration by the Society. Parties interested in participating in activities of the Society's IA Value Signalling Committee are encouraged to join. ■

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