INSIGHT

Uncovering hidden value

80% or more of an average company's value could lie in its intangible assets. Understanding the hidden value of a business is the key to communicating its importance to stakeholders.

2017 marked a milestone for Alphabet, the parent company of Google, when its market valuation passed $600bn for the first time. Where, though, does the bulk of that value lie? It is certainly not in real estate, buildings, fixtures and fittings—selling its tangible assets on the open market would raise only a tiny fraction of the company's worth. No, its value lies in its algorithms, its people, its culture and its brand.

In the past two decades or so there has been a sharp increase in the contribution of intangible assets to a company's value. The US-based intellectual property specialist Ocean Tomo carries out an annual appraisal of the value of the intangible assets of the Standard & Poor's 500: in 1975 17% of the total value consisted of intangible assets, but by 2015 that proportion had risen to 84%. Brand Finance's Global Intangible Financial Tracker 2016 (an annual review of the world's intangible value, known as the GIFT report) shows that only 53% of the $89 trillion total enterprise value of the 50,000-plus companies within the scope of the study consisted of tangible assets. In some sectors, the proportion was much lower, most notably in advertising, where tangible assets account for only 9% of the overall enterprise value.

Out of touch

This trend is fuelling a discussion of whether accounting has become out of touch with a new reality. Current accounting standards do not recognise intangible assets on the balance sheet unless they are separately identifiable (ie, they can be disposed of separately from the rest of the business) or a transaction, usually a business combination, has taken place that supports their valuation. That effectively limits the recognition of intangible assets to goodwill, patents, licences and trademarks and means that in any company, any detail on a significant proportion (and very possibly the vast majority) of its revenue-generating assets are missing from its primary financial statements.

"Financial reporting is in real danger of becoming irrelevant in this area," says Anthony Carey, partner at Mazars and the leader of its board effectiveness practice in the UK. "Accounting is best described as the language of business; it is essential that it reflects today's economy, not yesterday's.

"Intangibles are a company's key asset but there is no internationally recognised framework for reporting them in a meaningful way," he adds, "with the result that anyone reading the annual report usually won't get a good understanding of the assets of the company." This, he says, is a barrier to the effective functioning of the capital markets.

Reliable information

David Herbinet, global head of audit at Mazars, stresses that the profession needs to have a frank discussion, not about finding a way to put more intangibles onto the balance sheet, but "a broader one of how best to provide relevant and reliable information on intangibles for stakeholders in the most appropriate part of the corporate report".

"Accounting for intangibles raises some fundamental questions on the future of corporate reporting," he adds, "including, who should develop the framework and set standards, their content, and whether we need to lessen the distinction between the financial statements and narrative reporting."

There are options, albeit limited, for companies to discuss the hidden value in their business—through the (unaudited) narrative reporting sections of the annual report, for example. The thirst among investors for a better understanding of what drives

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the value of a business is persuading more and more companies to discuss their intangible assets. It is also fuelling an interest in integrated reporting, which explains an entity's 'story' through a combination of financial, environmental, social and corporate governance information. An integrated report would, for example, allow a board to discuss changes in the value of an intangible that results from a specific growth strategy or initiative.

Accepted framework

But while the International Integrated Reporting Council is working to develop a globally accepted voluntary framework for integrated reporting, there is no formal structure in place for companies to report the crucial but intangible drivers of their business. "It's extremely unusual for boards to publicly discuss intangibles thoroughly with appropriate figures attached, such as the levels of staff engagement and other people-orientated measures," says Carey. "We should have a framework that allows you to say: 'I really understand the value that's in my business.'"

"Boards understand what the key drivers of the business are, but good, detailed analysis will help to explain their understanding to investors and other stakeholders."

The UK's Financial Reporting Council (FRC) agrees with this view and has emphasised the importance of discussing all significant drivers of the business, even if they do not appear in the primary financial statements. The FRC's 2016 report, 'Corporate culture and the role of boards', for example, noted a rise in the measurement and reporting of metrics around corporate culture, an essential source of hidden value. Many UK companies, said the report, are already using "a range of information sources and tools to gain insights into culture and behaviours and make the intangible tangible". It added: "Traditional types of data and numerical indicators such as employee turnover can give a sense of scale and, as trends develop, a clear indication of the direction of travel and areas of potential concern. Targeted efforts to gather qualitative information from employees and other stakeholder groups, for example via focus groups or interviews, can inform a more comprehensive cultural assessment and highlight cultural risks which merit closer inspection."

"This is a key issue for the profession," says Carey. "A robust framework from standard setters or others is essential if we're to have consistent and insightful information for investors. No profession is guaranteed ongoing success, it must earn it by adapting to the changing needs of society." ●

THE FIVE MOST SIGNIFICANT SOURCES OF 'HIDDEN' VALUE IN A BUSINESS

- The **purpose** of the business. What does the company exist for? How does the board and management make sure that this is at the heart of the business and determines the decisions that are made? How is the purpose communicated to key stakeholders? The company's overall purpose should underpin the entire business, informing its strategy, supporting its values and driving the right behaviours.
- The **culture** within the business. While it is essential that an organisation has a strong ethical culture, the overall culture covers much more: What is the risk appetite of the business as a whole? In terms of decision-making, does it rely on team work or is there a focus on individual responsibility? Is the priority the long or short-term? If a business is to achieve its full potential it is essential that culture, strategy and capabilities are aligned.
- The business's commitment to **innovation**. In rapidly changing times, an innovative culture is critical to achieving long-term success. Innovation is not limited to R&D; it may take many different forms, including back-office organisation, communication and the use of data within the business.
- The **people** within the business. The FRC says incentives and values should be aligned: "Recruitment, performance management and reward should support and encourage behaviours consistent with the company's purpose, values, strategy and business model."
- **Brand** value. What is the board's strategy for protecting and nurturing the brand and creating social capital?
- Monitor and review the ongoing effectiveness of the **anti-bribery** programme.

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Anthony Carey
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Partnership
This article has been prepared in collaboration with Mazars, a supporter of *Board Agenda*.
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