

# Hidden assets

Putting a hard number on the intangible assets of companies is gaining value with supporters of accounting rule changes

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One casualty of the bust in Nasdaq stocks was the idea of intangible business assets. Amid bitter investor skepticism, such squishy items as research and development, software, employee training and brand power no longer stood any chance of being counted as real assets on corporate balance sheets, alongside such traditional assets as factories and equipment.

With stock prices plunging starting in 2000, and companies cooking their books, it's not surprising that investors were asking, "Where's the beef?"

Unfortunately, a useful debate about the nature of business and investing was shelved.

Maybe it's time, in a more sober investment era, to revisit intangible business investments and the role they play in generating long-term profits.

"Not everything that was said during the Internet bubble was a lie," said Gautam Dhingra, president of High Pointe Capital Management, a money management firm whose strategy compares intangibles among companies and industries. "But nobody wants to be associated with admitting that there might have been something useful about what was said."

At their worst, the hawkers of Internet stocks wanted to have it both ways. They exploited the tax advantages of deducting such business expenses as R&D and advertising. But they wanted investors to believe that these and other intangible investments should be counted as business assets, not routine expenses, as required by generally accepted accounting principles, or GAAP.

In other words, we were told the company's performance was actually much better than presented under GAAP.

In January 2002, when the Nasdaq bust was in full throttle, the Financial Accounting Standards Board, the rulemaking body for GAAP, began investigating whether companies should better highlight their intangibles.

The organization removed the project from its agenda two years later.

Ironically, intangibles are recognized as assets when a company is acquired, and the buyer pays more than so-called book value based on the cost of tangible assets.

If you bought Coca-Cola Co. for example, you would have to pay a lot more than the cost of the company's physical operations. You would have to pay for the Coke brand, which the company cannot count as an asset on its balance sheet.

Leonard Nakamura, an economist at the Federal Reserve Bank of Philadelphia, estimates that about half of the \$2 trillion businesses invest each year represents intangibles rather than plant and equipment.

As a rough estimate, about a third of the \$1 trillion in intangibles is

software; one third is intellectual property, such as R&D; and one-third is advertising and marketing, Nakamura said.

This means, in effect, that half of the business being managed by chief executives is not disclosed to investors as assets to be managed for the long term. Where's the corporate accountability in that rule?

Forcing a more prominent recognition of business intangibles could more accurately align the work--and pay--of CEOs with the long-term interests of shareholders.

Under current accounting rules, "investing in intangibles makes it harder to show a profit," even after deducting intangible items as an immediate expense for tax purposes, Nakamura said.

Managing intangibles is critical but risky, he said. "You can be conservative, but the bottom line is you have to deliver on the intangibles," Nakamura said.

"Although, in the short run, people are being more suspicious of intangibles," Nakamura said, he expects renewed interest in disclosing the full array of assets that CEOs are supposed to manage for shareholders.

Already, the International Accounting Standards Board, which helps develop accounting rules internationally, has adopted a standard for recognizing intangible assets created inside the corporation, as well as intangibles obtained through an acquisition.

It's by no means certain, however, that the Financial Accounting Standards Board, which writes rules for U.S. companies, will follow suit.

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Comparisons of companies give intangibles their due

U.S. accounting rules regarding intangible assets won't be relaxed any time soon.

This is a blessing in disguise for active investors.

You can develop a theory for how intangible investments generate profits and use the theory to compare companies.

Gautam Dhingra, president of High Pointe Capital Management, said it's like picking which of 10 basketballs is likely to bounce the highest.

Without knowing such absolutes as wind speed, air pressure in the balls and distance of the drop, it's impossible to know how high any ball will bounce. But if you simply squeeze the balls, you can estimate which ball will bounce the highest.

"The utility of this process from an investment point of view is in relative comparison," agreed Richard Evans, a pharmaceuticals analyst at Sanford C. Bernstein & Co. Here are some examples:

- Evans compares major drug companies according to levels of research and development expense, which is stated in financial reports, and their track records in converting R&D into profits.

"The reason it works for me in pharmaceuticals is that I can declare by fiat that the intangible [R&D] represents future product flow," he said.

For some reason, stock prices often fail to reflect the logical value of a

company's research effort, even though R&D spending amounts and historical R&D performance records are known, Evans said.

"The capital markets are relatively unable to deal accurately with intangible assets, which creates [investment] opportunity," he said.

- Dhingra assigns a "competitiveness score" to industries and companies, based on intangibles.

He examines such broadly comparable factors as barriers to entry and exit in the business, uniqueness of products and services, the ability to raise prices and the competitive landscape.

"We attempt to find companies that are the outliers, substantially superior or inferior, compared to industry norms," Dhingra said.

"We don't need an accounting rule to implement our process."

-- Bill Barnhart