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STRATEGY

Hiding in Plain Sight, or Sticking Out Like A Sore Thumb? The Wealth of Intangibles

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Financial reports of modern, knowledge-intensive firms are not only deficient, but also often inconsistent.

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21st century transformation of the North American economy is defined by the ascendance of modern technology corporations. Assuming that half of the U.S. **market valuation** comes from modern tech companies, the price tag of this transformation is a staggering $20 trillion. The combined market capitalization of just six tech giants—Apple, Alphabet (Google), Microsoft, Amazon, Meta (Facebook), and Nvidia—now eclipses the $10 trillion mark. The significance of this figure can be judged from a straightforward comparison—$10 trillion surpasses the **entire Gross Domestic Products** (GDPs) of France, the United Kingdom, and Canada combined

We present two remarkable insights regarding the financial reports of modern technology companies that every corporate leader must comprehend for informed decision-making. First and foremost, it is crucial to recognize that tech companies' most valuable assets do not appear on their balance sheets. For instance, companies such as Apple, Google, Microsoft, Amazon, and Facebook have some of the world's **most valuable brands**; however, their brand values are conspicuously absent from the balance sheets. Equally astonishing is the second fact: these very companies meticulously assess and report any intangible asset acquired from external sources. This article sheds light on puzzling inconsistency between the reporting of internally developed versus externally acquired intangible assets. Subsequently, we delve into the actions that managers, investors, boards of directors, and management consultants must take to improve their decision-making processes based on financial reports.

Consider Apple, the current frontrunner, as the world's most valuable company. Its reign at the pinnacle is underpinned by three intangibles: its brand name, relentless technological innovation, and a sprawling ecosystem of devoted customers and partners. Intriguingly, these invaluable assets remain conspicuously absent from Apple's balance sheet. Instead, accountants would opt to record tangible assets like factories, land, buildings, warehouses, ships, and oilfields, of which Apple possesses relatively little. Consequently, Apple reports book value of its equity shares at a mere **$60 billion**, a stark contrast to its towering market capitalization of three trillion dollars. The chasm between these figures is so vast that reconciling them is an insurmountable task. More significantly, relying solely on Apple's balance sheet numbers would lead to disastrous decisions for anyone, from its board members to bankers and investors.

Adding to this omittance is another perplexing aspect—reporting of acquired intangible assets—perfectly exemplified by Meta (Facebook). Facebook is a brand renowned worldwide, and its platform brings together a staggering **3 billion monthly active users**, positioning it as the most "active" social media platform globally. The brand and platform **contribute** to its impressive $120 billion in revenues and $28 billion in profits. Astonishingly, neither of these internally cultivated assets—the brand name nor the expansive subscriber network—is recognized as an asset in financial reporting. Strangely, Meta includes on its balance sheet the less significant assets it has acquired through purchases. For example, when it acquired WhatsApp in 2014, it meticulously assessed and assigned a value of $448 million to WhatsApp's brand name, $2,026 million to its customer base, and $288 million to its technology. All three of these assets of WhatsApp were duly recorded on **Facebook's balance sheet**, creating a paradox wherein purchased assets found their place in financial statements, while the internally developed assets that are arguably ten or even a hundred times more valuable go unreported.

This perplexing and incongruous phenomenon finds another striking example in the case of tech giant Microsoft. Microsoft's internally developed technology, brand, and customer relationships, each of which arguably commands greater value than numerous Fortune 500 companies and serves as the bedrock of Microsoft's staggering $2.5 trillion valuation, do not appear as assets in its balance sheet. A reader would be taken aback by the $157 million that Microsoft assigned to Nokia's tradename and the $2,493 million it allocated to Nokia's technology as part of the Nokia-Microsoft 2014 acquisition deal. This stark contrast again highlights the omission of the colossal value of homegrown assets while underscoring the prominence of acquired assets in financial reporting.

Below are some more examples of this puzzling reporting conventions:

- In 2006, AT&T's acquired BellSouth and valued the acquired intangible trademarks, licenses, customer lists, and patents at $10 billion. A parallel saga unfolded in 2015 when AT&T acquired DIRECTV and valued the acquired intangible assets of orbital slots, trade names, and customer lists at $36 billion. Curiously, AT&T would not report its own brand name or its legendary homegrown technology on its balance sheet.

- Pharmaceutical giant Pfizer acquired Wyeth in 2009. Pfizer would include Wyeth's intangible assets, such as technology rights, brands, in-process research and development, in its assets at $52 billion. Similarly, Merck acquired Schering Plough Corporation in 2009, and recognized $41 billion of acquired intangibles such as product & product rights, tradenames, and research initiatives. In contrast, neither Pfizer nor Merck, the acquirors, would report the true worth of their own brand name or self-developed assets in the balance sheet.

- Bayer AG's acquired Monsanto in 2018 and identified Bayer's intangible assets such as patents, technology, trademarks, marketing rights, and R&D projects at €27 billion. But Bayer wouldn't report its own more valuable homegrown assets.

- More recently, in 2022, S&P Global acquired IHS Markit Ltd. and valued acquired customer relationships, trade names, trademarks, developed technology and databases at $19 billion.

- This is not just a U.S. phenomenon, where accounting rules differ from International Financial Reporting Standards (IFRS) that are followed by the rest of the world. Consider Hindustan Unilever's acquisition of GlaxoSmithKline Consumer Healthcare in 2020. Curiously, the Indian subsidiary of Unilever, the acquirer, valued GlaxoSmithKline's trade names like Horlicks at about $3 billion. But Unilever would not consider its own fabled, homebuilt brands as valuable assets. In 2018, Walmart acquired a 77% stake in Flipkart and valued the acquired trade names at about $5 billion. The same Walmart would not consider its own tradename, one of the most recognized one on this planet, as an asset worth reporting.

Here's another intriguing observation: in nearly all instances, the acquirer's reports a value of acquired intangibles far exceeding the value that the target company ever reported on its own balance sheet for the same assets, if it reported them at all. As a result, assets that previously never surfaced on any balance sheet suddenly emerge as highly valued assets of the merged entity following an M&A transaction.

Why should managers care?

Undoubtedly, intangible assets stand as the pillars of modern corporations, enabling them to secure competitive edges and generate enormous revenues and profits. Frequently, the self-developed intangibles, such as Google's proprietary search algorithm and **Coca-Cola's** closely guarded secret recipe, propel a company to astronomical valuations. These valuations, in turn, empower the company to engage in acquisitions to obtain additional intangible assets from other companies. This, however, leads to a puzzling and incongruous distinction between acquired and internally developed intangibles. In our perspective, it is imperative for corporate leaders to comprehend this distinction for informed, data-based decision making.

1. **What is it worth**: For a long time, value investors looked up to legends such as **Benjamin Graham** and **Warren Buffett**, in relying on book values to guide their investment and divestment decisions. However, it has become evident that sticking to those principles would now yield substantial losses. Consider, for example, Graham's counsel to steer clear of companies whose market values exceed 1.5 times their book values. Apple, by that measure, was never an attractive investment. Today, Apple's market value surpasses its book value by over 50-fold. This serves as a poignant reminder that evaluating a company's worth solely based on its balance sheet can result in enormous losses. As such, investors must look beyond the numbers to truly grasp a company's intrinsic value.

2. **Make-versus-buy**: Considerable **literature** exists on this pivotal decision—whether firm should buy or build its key assets. We add one more factor now. Buying intangible assets would increase a firm's assets but would have no immediate impact on the company's profits. In contrast, making intangible assets would not change **balance sheet** but increase firm's **reported losses**. So, managers must be careful not to mechanically rely on financial numbers; otherwise they will miss the real cost-benefit tradeoffs involved in a make-versus-buy decision.

3. **Evaluating profitability**: The Board of Directors reward senior managers for profitability, calculated with ratios such as net income or earnings before interest depreciation and amortization (EBITDA) divided by total assets. EBITDA might not exhibit a significant difference between two companies: one growing through

acquisitions, and the other relying on internally developed intangibles. But their profitability ratios would differ dramatically, affecting CEO compensation. This must be corrected to properly incentivize senior management.

4. **CEO incentives for growth**: Boards of directors frequently incentivize senior managers based on growth metrics, which may encompass assets. This practice could inadvertently promote the acquisition of intangibles or the construction of tangible assets instead of fostering the development of in-house competencies. The numbers must be recalculated to set appropriate incentives for value-added growth.

5. **Rethinking credit evaluation**: Banks evaluate a company's creditworthiness by relying on ratios like debt/equity and asset coverage. However, the emphasis on reported assets in these calculations ignores the value of home-grown intangible assets while overemphasizing acquired intangible assets that may command little secondary market values. Bankers must conduct a more holistic evaluation that recognizes the real intangible assets that contribute to a company's creditworthiness.

6. **SWOT analysis**: Managers periodically conduct assessment of the firm's strengths, weaknesses, opportunities, and threats (SWOT) for strategic decision-making. However, overweighting acquired assets and ignoring homebuilt competencies for this analysis, would leave large gaps in understanding of firm's true situation. It will lead to an incomplete perception of the company's capabilities and vulnerabilities. Managers need to holistically analyze intangibles to develop a well-rounded SWOT analysis.

The corporate landscape is undergoing a swift transformation, propelled by the growing prominence of intangible assets. Embracing the intricacies of this intangible-driven economy, all while remaining mindful of the idiosyncrasies and shortcomings in the reporting of intangibles on corporate balance sheets, is now an essential lesson for managers. They must realize the prominent inclusion of acquired intangibles and the conspicuous absence of self-developed intangibles in balance sheets. The phenomenon we describe must baffle most corporate leaders, especially those who adhere to the maxim: "If you can't measure it, you can't manage it." A more profound analysis that transcends the confines of reported figures would ensure a more precise understanding of a company's overall worth, performance, and future potential.

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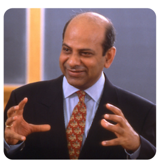

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