

Future value: The \$7 trillion challenge

By John J. Ballow, Robert J. Thomas and Göran Roos

Nearly 60 percent of the aggregate value of the US stock market is based on investor expectations of future growth. And because this future value tends to be concentrated in industries and companies that are built on intangible assets, it is critical to find better ways to recognize, report and manage these assets.





■ As if CEOs didn't already have enough headaches trying to make their quarterly and annual numbers, these days many of them are also under increasing pressure at the longer-term end of the spectrum—in the form of investor expectations about future growth. Indeed, the whole issue of “future value”—that portion of a stock's price that does not depend on current operating performance but rather on the company's anticipated growth—is one of mounting concern to C-level executives faced with the task of delivering share-price performance in a difficult economic climate.

Future value is not, of course, a new concept. Nor is it equally important in all parts of the economy. It is, however, especially critical in newer industry sectors and among companies whose value is based heavily on intangible assets such as brand and proprietary knowledge—in other words, industries and companies that are among the most important to driving the economy.

Consider this: To justify its lofty share price, one highly esteemed new-economy company will need to grow revenues by a staggering 60 percent a year over the next decade. At least, that is what an analysis of the company based purely on its current operating results suggests. A share price so closely linked to future value could be considered at risk.

A similar analysis of the entire US stock market shows that as of May 2003, there was an extraordinary \$7.6 trillion at risk—an amount that represents 58 percent of the aggregate value of the US stock market, as measured by the Russell 3000 Index. And this is not just a US phenomenon: A

joint *Financial Times/Stern Stewart & Company* study of the UK stock market in September 2000 showed £864 billion of equity value at risk among just the largest 200 listed companies.

Key value drivers

Clearly, the potential market impact of future value is dramatic. If the means to analyze, report and manage future value were commensurate with this impact, CEOs could take comfort. But in fact, as many CEOs appreciate, powerful trends have put the two far out of sync.

During the past 25 years, intangible assets have supplanted tangible assets as the key value drivers in the economy. At the same time, traditional accounting has remained focused on tangible assets. As a result, a significant portion of corporate assets go unrecognized and underreported. And because it is difficult—some would say impossible—to manage what is not being measured, many of the assets that are most responsible for creating value in today's economy are not managed as well as they could be.

Many C-level executives rely on fiscal-year, accounting-based financial data to run their businesses; they focus on current operating results, and they use those results to form strategies that do not necessarily optimize future growth. In managing for today, they use relatively straightforward accounting methods to link their own management decisions to stock market impact. But when it comes to managing for tomorrow, the basis for making these connections is far more tenuous.

The inadequacy of current accounting methods in a knowl-

edge-driven economy—and the search for more suitable methods—is not news. In fact, articles on the subject began appearing in the business and academic press in the late 1970s, and they became more common during the mid-1990s. Formal methodologies such as economic value added and the balanced scorecard are just some of the more visible evidence of the lively interest in the subject among financial regulators, accounting professionals, consultants, stock exchange officers and businesspeople.

In fact, a recent joint Accenture/Economist Intelligence Unit study confirmed that today's senior executives see managing intangible assets as a major issue. Fully 94 percent consider the comprehensive management of intangible assets important; 50 percent consider it one of the top three management issues facing their company.

At the same time, executives say performance measurement of intangible and intellectual capital

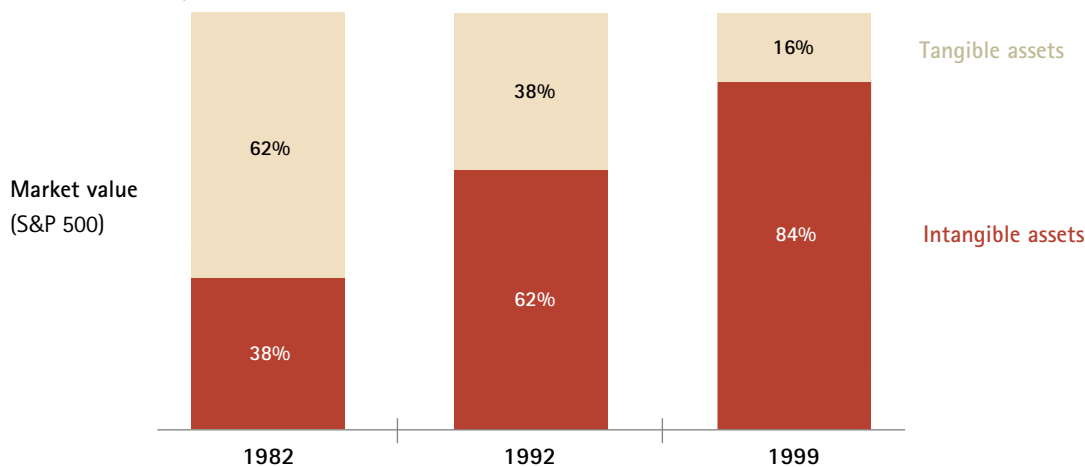
assets is insufficient or even nonexistent. Only 5 percent of surveyed executives claim their company has a robust system that measures and tracks all aspects of the performance of these assets. Sixty percent say they apply only some of these measures, and one-third do not measure the performance of intangible assets or intellectual capital at all. Clearly, there is a wide gap between awareness of the issue and success in addressing it.

Defining assets

Accenture is committed to building a meaningful understanding of future value and helping companies manage it better. As part of our companywide high-performance business initiative, we have developed a set of tools to precisely break down and analyze the constituent components of future value; a comprehensive research database that examines drivers of future value from both industry- and context-dependent perspectives; and a methodology for applying the tools and research on a company-specific basis.

Changing asset base

Over the past two decades, intangible assets have become the key value drivers in the economy.



SOURCE: JUERGEN H. DAUM, *INTANGIBLE ASSETS AND VALUE CREATION*, JOHN WILEY & SONS, 2002

Defining intangible assets

Broadly speaking, all asset classes can first be categorized as either “traditional” or “intellectual capital.” As the grid below shows, each of these categories has subcategories—and both tangible and intangible aspects. For accounting purposes, there is not much disagreement over what comprises tangible assets. The definitions of intangible assets, however, vary widely; the narrowest includes only components such as brand equity, formal intellectual property and patents, and human capabilities (based on training).

Accenture favors a more expansive definition that also includes dynamic business attributes such as knowledge-creating capability, right of access, the ability to use information, operating procedures and processes, management capability, the ability to execute strategy, innovativeness and real strategic options.

	Traditional accounting assets		Intellectual capital assets		
	Monetary	Physical	Relational	Organizational	Human
Tangible assets	<ul style="list-style-type: none"> • Cash • Investments • Receivables/debtors • Payables/creditors 	<ul style="list-style-type: none"> • Property • Plant • Equipment • Inventory <ul style="list-style-type: none"> ◀ Finished goods ◀ WIP ◀ Parts/raw materials 	<ul style="list-style-type: none"> • Customer contracts • Formal alliances (e.g., JVs, supply agreements) 	<ul style="list-style-type: none"> • Systems • Formalized processes • Codified knowledge • Patents • Brands • Mastheads 	<ul style="list-style-type: none"> • Acknowledged skill sets • Experience • Employee loyalty
Intangible assets	<ul style="list-style-type: none"> • Credit ratings • Undrawn facilities • Borrowing capacity (relative to like companies, based on character) • Unused borrowing capacity • Receivables and accruals certainty • Quality of earnings • Balance sheet strength 	<ul style="list-style-type: none"> • Plant flexibility • Plant modernity • Plant infrastructure • Stranded assets • Tradability of facilities • Access rights • Plant regard (“can do,” “will do”) • Inventory (good, obsolete, redundant) 	<ul style="list-style-type: none"> • Customer loyalty <ul style="list-style-type: none"> ◀ Behavioral ◀ Attitudinal • Quality of supply contracts • Right to tender, right to compete, right to design • Strength of stakeholder support (including opinion leaders) • Networks • Regulatory imposts 	<ul style="list-style-type: none"> • Structural appropriateness • Informal processes • Organizational reputation • Brand meaning (strength, stature) • R&D productivity • Quality of corporate governance • Know-how • Tacit knowledge 	<ul style="list-style-type: none"> • Top management quality • Top management experience • Ability to execute on strategy • Capabilities • Problem-solving ability • Employee loyalty <ul style="list-style-type: none"> ◀ Behavioral ◀ Attitudinal • Personnel reputation

SOURCE: ASSETECONOMICS HOLDINGS

Central to our work is an understanding of what constitutes “intangible value” (see sidebar, opposite page). The answer is more complex than might be expected; it depends not only on what companies themselves determine but on the consensus of their investors and other major stakeholders.

To define and classify assets, Accenture incorporates research done by AssetEconomics, a strategy advisory firm, that considers both the form of the asset—monetary, physical, relational, organizational or human—and its *recognizability*, that is, its tangible or intangible characteristics. A traditional monetary asset like cash, for example, is tangible; “borrowing capacity” would be an intangible aspect of monetary assets. Similarly, patents would be a type of tangible organizational asset, while “R&D productivity” would be an intangible organizational asset.

The distinctions are important. First, they illustrate the limited focus of current accounting, which considers just the tangible aspects of traditional monetary and physical assets. Second, they show how companies can overlook large categories of shareholder-value drivers, which in many industries are the principal contributors to share price.

Accenture’s work in the area of human capital, for example, has shown that the value created by investment in employee recruitment, training and professional development, and retention can be precisely measured (see “Boosting your workforce performance ROI,” *Outlook*, Vol. XV, No. 2, May 2003). Moreover, those diagnostics can be applied strategically at the business-unit or enterprise level

to produce measurable increases in shareholder value.

To illustrate the impact of an intangibles-driven perspective, consider the actual case of a leading global pharmaceuticals company. In 1997, 80 percent of its share price was based on future value; assuming that future value is the difference between a company’s market cap and its current value of daily operations (into perpetuity), only 20 percent of the pharma’s share price was actually based on its current value. An analysis of the stock’s history showed that the markets rewarded the success of its R&D investments. But traditional accounting recognizes R&D only as an expense, and it therefore has a negative impact on earnings per share. Because the company’s performance metrics and annual incentives were based on earnings per share, senior executives tried to minimize R&D spending.

Undervalued, undermanaged

Future-value analysis showed the company was very well managed—for the traditional asset classes it recognized. But the same analysis showed that the value of current earnings actually represented just 2 percent of the company’s total market value (using the general rule of thumb that capitalized current operating value equals 10 times current earnings). This 2 percent was the focus of the company’s budgeting, planning, management systems, variance analysis and month-to-month tracking. This means the other 98 percent of the company’s market value was undermanaged. Based on the future-value analysis, senior management increased its R&D “expense” by £140 million and its R&D capital expenditures by £90 million. The company’s stock rose dramatically when these investments were announced.

Current accounting considers only the tangible aspects of traditional monetary and physical assets.

Future value is not evenly spread throughout the economy. Indeed, it is highly industry-specific. Share prices in newer industry sectors tend to reflect a higher proportion of future-value expectations than those in mature ones. Similarly, industries based heavily on intangibles such as brand and proprietary knowledge generally have higher future-value quotients than those with heavy fixed-infrastructure investments. Our analysis of the Russell 3000 Index shows that future value as a percentage of enterprise value ranges from a low of 16 percent for sectors such as banks or consumer durables and apparel to highs of 106 percent for media and 127 percent for technology hardware (see chart, below).

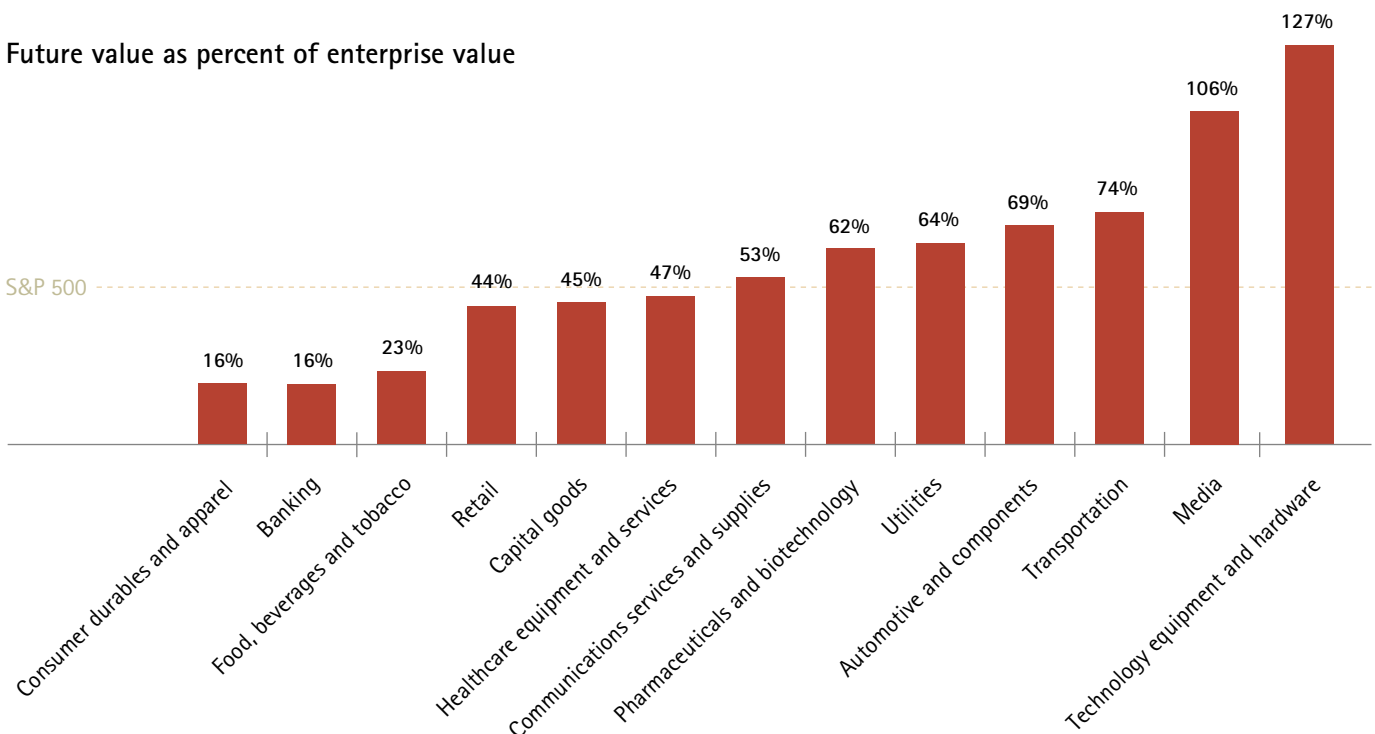
Still, similar companies, even within the same industry, can have very different future values. If a company's future value is lower than that of its peers, then senior executives should understand why, and they should develop a plan to get its proper value recognized. At the same time, if a company's future value is a very high percentage of its overall value, its executives, too, must understand why and intently manage the company's key value drivers.

Failure to do so can result in a fall in market capitalization if the market loses faith in the company's ability to meet its expectations. Therefore, while certain industries may have higher average future values than others, all companies

Industry-specific

Future value varies dramatically from industry to industry. In general, industries in which intangibles play a big role have higher future value than those with heavy fixed assets.

Future value as percent of enterprise value



SOURCE: ACCENTURE ANALYSIS; RUSSELL 3000 INDEX

need to understand and manage future value.

What could companies do to better deal with this situation? Industry benchmarking could be supplemented by research on the impact of business conditions. However, analytic modeling that more accurately captures the behavior of intangible assets is necessary as well.

Intangible assets behave differently than tangible assets, as anyone who has witnessed the overnight destruction of a brand knows. 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 interdependent, and their value depends on the industry and competitive context.

We have found that many CEOs believe that if they deliver good current-year operational results, share price will take care of itself. However, share price, of course, doesn't always act in predictable ways. The tides of investment fashion and the fact that there is a relatively small universe of market makers for any given stock affect share price. For the C-level executive focused on managing shareholder value, key issues include the diverse expectations and varied perceptions of value among prospective investors.

The very lack of a universally accepted method of valuing intangibles makes this challenge all the more acute. Only half of our survey

respondents believe that stock markets reward companies that invest in intangible assets and/or intellectual capital, even when there is adequate disclosure of these investments. We think careful analysis of the potential market reaction is an integral part of future-value management. In this case, value—like beauty—is in the eye of the beholder.

Our experience has shown that traditional financial modeling tends to miss these behavioral dynamics—the relationships among intangible assets themselves, and the way they're perceived in the marketplace. Accenture and AssetEconomics are pioneering alternative, dynamic approaches that take these patterns into account and deliver better insight. The advent during the past few years of new and substantial streams of previously inaccessible data, thanks to comprehensive corporate investment in enterprise systems, facilitates the analysis.

Rewarding investment

As discussed above, future-value analysis is most effective when it is company-specific. To show how the future-value analytic model works in action, consider a US software company with a signature consumer product that derives nearly 97 percent of its enterprise value from future-growth expectations. It can be reasonably assumed that the market is expecting investments in R&D, marketing and goodwill to fuel this future growth. The analysis of the stock's historical performance shows that the marketplace has rewarded the company for investing in these intangibles, by increased future-value multiples of 15 to 30 times the investment amount.

Suppose this company could create a sustainable gross profit

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increase of \$1. What should it do with the money? If it takes the \$1 as profit—and since its executives' pay is tied to profitability, it is likely they would want to do this—we calculate it would lead to \$6 of additional value. However, we think that if management instead invests in areas such as R&D and marketing, it would lead to a remarkable \$19 to \$34 of increased value—a massive difference that is not easily understood without a clear understanding of future value.

Strategic applications

Currently, no US companies include accounting for intangibles—in the full sense outlined here—in their annual reports. Prominent companies such as General Electric and Coca-Cola are stepping even further away by not providing guidance on quarterly earnings estimates. Work is under way with professional-standards groups like The American Institute of Certified Public Accountants and with rule makers like the Financial Accounting Standards Board to look at a language for reporting on intangibles. In the meantime, the US legal system and the current regulatory climate (for example, the 2002 Sarbanes-Oxley legislation on corporate governance and reporting) inhibit US companies from experimenting with formal future-value reporting.

Most of the companies that have ventured into formal future-value reporting reside in jurisdictions that do not have these particular constraints. The European Union has been the source of much of the theoretical work to develop a new understanding of intangibles and future value as well as the location of the best-known future-value strategic applications. This trend

will continue for the foreseeable future. In fact, Denmark and Austria recently became the first countries to encourage the reporting of certain aspects of intangible assets.

Many C-level executives today know which levers to pull to have an impact on traditional assets. They are less informed about which levers to pull to sustain and grow the value of their intangible assets. With the growing importance of intangibles, their need to equalize these managerial abilities is clear.

Their model may lie in the example of companies that, intentionally and methodically, have mastered various components of the knowledge economy. These industry leaders, tellingly, have garnered the lion's share of all market value added during the past several years, as measured in total return to shareholders.

We've seen the business press treat success in managing intangible assets as separate stories—about, say, investment in brand, or governance reform, or copyright law advocacy or knowledge management. However, we believe these articles often miss the key point—that these successful companies are prototype masters of intangible assets and, as such, avatars of high performance.

Our research indicates that a number of companies are eager to join this group, although to date they have lacked a viable operational framework to translate their own intangibles into manageable market value. In the next several months, Accenture and AssetEconomics will continue to outline their perspective on future value and intangible-assets management,

along with the results of additional industry and company research.

With more than \$7 trillion worth of the US stock market based on future value and with current management approaches ill-suited to managing it well, the need for a better approach is more critical than ever. ■

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