Intangibles – selecting the right tools for the job

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Intangible assets, intellectual capital, knowledge-based resources, human capital – such a deluge of new concepts and techniques has surfaced to name and measure intangible resources that it has become difficult to see the wood for the trees. Managers should start by asking themselves 'what is the problem I'm trying to solve here?'. **Daniel Andriessen**, a senior manager at KPMG, provides you with a checklist.

The intangibles perspective

Once every few years a new perspective on organisations is born, providing management with a new point of view and offering new solutions to newly identified problems. A perspective that has attracted considerable attention in recent years is looking at an organisation as a combination of tangible, financial and intangible resources. Intangible resources have become more and more important in producing products and services.

Companies have gone 'soft', shifting from tangible to intangible, so that many are now virtually weightless. The drivers of wealth are brands, networks, knowledge, competences, corporate culture and leadership, just to name a few.

> More time should be spent on managing resources

Adopting this perspective is forcing companies to see things in a new way, identifying new problems and risks. For example, typically, much time is spent optimising the process of managing financial and tangible resources, but far less on managing important resources like knowledge or brands. Accounting systems are very sophisticated when accounting for financial and tangible assets, but tend to treat most investments in intangibles as expenses.

Performance of financial intangible assets is always measured, but information on the performance of intangible resources is generally lacking.

The solution generators

With this new perspective came the solution providers and sellers of consulting services. Over the past five years a tremendous amount of literature has been published on the measurement and management of intangibles, stemming from various communities:

- the intellectual capital community builds on the work of people like Thomas Stewart and Leif Edvinsson and offers various models for measuring intellectual capital;
- the accounting community is struggling with a decrease in relevance of traditional financial information and is working on ways to recognise intangible assets in financial statements;
- the performance measurement community has adopted the concept of intangibles to add credibility to its approaches for measuring performance, like the balanced scorecard;
- the valuation community is creating more and more sophisticated tools for coping with the highly uncertain nature of intangible value, using concepts like real options;
- the financial analysts' community is working on new ways to measure the true value of companies, using tools like economic value added (EVA™); and
- within the human resources community we are seeing a revival of the human resource accounting (HRA) techniques from the 1970s.

Er... what was the problem?

With so many solutions floating around, you stand to lose sight of the problems these approaches try to solve. In many cases these tools seem to be 'solutions in search of a cause'. Therefore, when you are considering implementing a tool for measuring intangibles, you should first consider what the problem is you are trying to crack. The box (opposite) provides a checklist of common problem definitions found in the literature regarding the measurement of intangible resources.

> Some tools are 'solutions in search of a cause'

As it shows, there are many ways of defining the intangibles measurement problem. Some problem definitions may partially overlap, others will correlate. In general one can distinguish between problems associated with the internal management of the organisation and problems that have to do with external reporting. You can use this checklist to determine your key area of interest regarding intangibles and then select the appropriate tools. Each of the 10 problems is discussed briefly.

IMPROVING INTERNAL MANAGEMENT

Improving the management of intangibles?

Tools claiming to improve the management of intangibles are often based on the notion that intangible resources (commonly named intellectual capital) are the most important drivers of business value, but receive the least management attention. Based on the adage, 'what gets measured, gets managed', they promote the detailed measurement of stocks and flows of intellectual capital, using all sorts of indicators. A well-known example is the 'Navigator', developed by the swedish insurance firm Skandia and promoted by Leif Edvinsson.

Creating business strategies

Kaplan and Norton in their latest book, 'The strategy focused organisation', admit that their balanced scorecard is not so much a tool for solving the performance measurement problem as a tool to clarify and implement strategies. Many companies are looking for ways to align business strategy to opportunities offered by the knowledge-based economy. A method like KPMG's Value Explorer® provides insight into the stock of intangible resources that companies can use to develop new resources-based strategies.

Improving financial results

Knowledge-intensive companies that operate with little financial and tangible assets and that invest heavily in intangibles like research and development (R&D), often show poor financial performance. Then it becomes tempting to improve the balance sheet and current profits by capitalising investments in intangible assets that are otherwise treated as an expense. Current accounting regulations offer limited possibilities for doing so. Some authors claim that the '500 year old system' should therefore be drastically reformed; others warn we should not throw out the baby with the bath water.

Weighing investment opportunities

The intangible value measurement (IVM™) approach developed by Professor Philip M'Pherson of Systems & Value Ltd is one of the most robust approaches to the measurement of intangible resources I have come across. A similar tool, the IC-Index, has been developed by the London-based Intellectual Capital Services (ICS). Using a series of indicators the method calculates one overall measure of business value. This tool is especially suited to measuring the impact on business value of investment opportunities and it serves as an aid for cost-benefit analysis.

Enhancing the management of the business

Some tools claim to enhance the management of a business as a whole by focusing on the creation of intangible value. For example the economic value added (EVA™) concept introduced by Stern Stewart can be used to measure whether the overall management of a business is aimed at creating shareholder value.

> Book and market values cannot be compared

IMPROVING EXTERNAL REPORTING

Closing the value gap between book and market value?

A popular misconception in literature is that the difference between the book value and market value of a company equals the value of its intangible resources. Even more popular is the notion that this value gap poses a problem and needs to be closed.

Comparing book and market values is like comparing apples and pears. It is not possible mathematically to subtract one from the other.
The gap has many causes, including the rising importance of intangibles. As such it is not a problem, as it has never been the objective of financial statements to make stockholders' equity equal market capitalisation.

Improving predictability of future performance

What is more worrisome is the fact that reported earnings are playing a decreasing role in the total information affecting investors' decisions.

Research shows a decreasing pattern of association between stock prices and key financial variables, such as earnings, cash flow and equity values. Of course investment decisions are made based on more information than available through the financial statements. Research shows this information is becoming more important. This may lead to an increase in information asymmetry among parties operating on the stock market, ie between the 'knowers' and the 'don't knowers'. This in turn may increase the cost of capital.

Reducing information asymmetry

Reducing information asymmetry is the objective of the value chain scoreboard™ proposed by Baruch Lev. Its aim is to enable all constituencies – from individual investors to professional financial analysts – to make decisions at the level of professional investors and managers. This is in line with what Baruch calls, 'the democratisation of the capital markets'. In essence, his scoreboard is a set of indicators at each stage of the enterprise's value chain, to be reported on a regular basis. These indicators focus in particular on intangibles.

Clarifying and controlling communications with stakeholders

As financial statements become less relevant and the instant availability of other enterprise-related informa-

Checklist of problem definitions

Improving internal management

- ✔ Improving the management of intangibles
- ✔ Creating business strategies
- ✔ Improving financial results
- ✔ Weighing investment opportunities
- ✔ Enhancing the management of the business

Improving external reporting

- ✔ Closing the value gap between book and market value
- ✔ Improving predictability of future performance
- ✔ Reducing information asymmetry
- ✔ Clarifying and controlling communications with stakeholders
- ✔ Enhancing corporate reputation

tion is increasing (as a result of the media and the internet), clear and focused communication to stakeholders becomes paramount. This includes information on where the real value – current and future – lies in an organisation. KPMG's 'Beyond numbers™' approach deals with all aspects of non-financial performance reporting. It helps companies build a total value reporting culture and to deliver the right corporate messages to the right stakeholders at the right time. This allows more informed commentary by analysts, thereby bringing share prices to levels more commensurate with business performance.

Enhancing corporate reputation

Investors increasingly incorporate social, environmental and ethical performance into their decision-making process. As a result there is an increasing demand for information on non-financial performance. Companies need to prove they are behaving responsibly at the risk of losing reputation. This includes a responsible way of managing their intangible resources. (This demand not only acts as a threat but also an opportunity as was proven by Skandia. The exposure created by the Skandia Navigator boosted the market recognition of its brand.)

> The intangibles problem is often part of a larger issue

Conclusion

There are many good reasons for measuring and reporting intangible resources. Selecting the appropriate approach is often difficult. The key is to define carefully the problem you want to solve. Each problem will require a different approach. In most cases this problem will stretch further than managing or reporting intangibles. As is clear from the checklist, the intangibles problem is often part of a larger business issue. Therefore in most cases the adopted solution will need to go beyond pure measurement of intangibles. F&M

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