

Value Creation in the Knowledge Driven Economy

MARIA

Managing And Reporting Intangible Assets

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1 FOREWORD

AIMS

1.1 This project, aims to help UK organisations understand and manage the various investment areas necessary to make best use of overall tangible and intangible resources.

1.2 The aims of the project are to establish: -

- “What are organisations’ key intangibles and how should they be managed to create value”.
- “What are the issues to be considered in prioritising the allocation of investment in intangibles”.
- “How might an organisations’ reporting be enhanced to provide a stronger foundation for a better quality dialogue with all those who have a legitimate interest”.

DRIVERS OF CHANGE

1.3 Advances in computing and communicating are increasingly used to develop new ways to do business and to keep track of the activities of competitors.

1.4 Learning from others and using the knowledge gained to adapt activities in order to develop multiple worthwhile relationships remains at the heart of running a successful organisation.

1.5 Opportunities for expansion into new products and new markets has increased but the time available to do so before copy cat business steals the window of opportunity has also increased.

1.6 All organisations need to continually develop strategies and adapt tactics to make best use of new knowledge and their overall portfolio of tangible and intangible assets within the dynamic “business to business” and “business to consumer” marketplace.

MANAGING AND REPORTING INTANGIBLE ASSETS

1.7 On one hand, we note strong resistance from organisations visited to any notion that individual intangibles should somehow be identified, valued and recorded as part of financial reporting.

1.8 On the other hand organisations do recognise intangibles as things that are of vital importance and they are keen to enhance ways of measuring, developing and extracting value from them.

1.9 To become proficient, organisations need to develop a range of tools which together address both tangibles and intangibles.

2 ACCOUNTING & MARKET VALUE

2.1 The basic principle that underpins the market value of a business is future cash flow. The challenge lies in estimating what these cash flows are going to be.

2.2 Financial accounting applies a common set of rules which enables reporting on a consistent basis throughout an organisation. This consistency provides “values for accounting purposes” and “profit for accounting purposes” for specific accounting periods, however, as you aggregate figures; important messages about investments made to support key future cash flow can be lost in the consolidation process. Financial accounting is simply not equipped, to record the richness of elements necessary to understand the market value of a business based on the overall portfolio of tangibles and intangibles. Even if individual elements of market value could be identified and quantified in financial terms, there would still be a reporting problem because of timing differences between the accounting period(s) for investment and the accounting period(s) for realisation.

NEED FOR ADDITIONAL FORMS OF REPORTING

2.4 The challenge is to provide evidence to support the probability of a successful future. Track record is one thing, but what is it about this organisation that gives confidence, to those who have an interest, that it will succeed and create value in their eyes?

2.5 In many cases precise measurement of enabling intangibles may not be either possible or desirable but indicators can be used to fulfil the normal management process of measurement against targets.

2.6 The value of reporting, lies in understanding where the organisation currently stands regarding its various and varied intangible investments and how to prioritise investment, including motivation and reward issues, to support future prospects of success.

2.7 Any organisation which seeks to buy or sell any part of a business, any financial investor or anyone considering a future business relationship needs to consider the value in intangibles.

3 UNDERSTANDING INTANGIBLES

3.1 Our experience and intuition tells us that tangibles are far from being the only sources of competitive advantage, yet those intangible things which make up the difference may seem difficult to quantify and, therefore, to manage precisely.

3.2 Since these other valuable things tend not to arise directly as a result of financial transactions they are not to be “accounted for” within financial reporting and even if identified in other ways, traditional valuation methods for tangibles like “replacement cost” or “marketplace consensus” are problematic for valuing intangibles.

3.3 Conventions over some ‘intangibles’, such as brands and intellectual property, have been a source of lively argument for some years. In other cases, intangibles such as employee skills and culture have often been touted as key elements of competitive success, albeit surprisingly difficult ones to manage effectively.

3.4 Recognising what is valuable and also what destroys value is central to management of the overall resource base of a business. In this respect, managing intangibles is essentially the same as managing tangibles, it’s largely about working with knowledge for the mutual benefit of relationships.

3.5 Maintaining profitable relationships is all about understanding that which is valued by each other, this of course, includes relationships with those internal customers, who we work with, as well as end users. Relationships bring in ideas and problems to solve also aspirations to meet. Equally, partnerships and networks bring in ideas and tools to assist innovation and development of value creating solutions.

3.6 We all know intuitively that intangibles are important, even if slippery to define, but just what should be considered when, for example, judging a sensible valuation for the sale or the purchase of a business or when trying to influence a prospective new client or member of staff. Apart from a sense of track record, consideration of future prospects, frequently, has little to do with financial accounting.

4 THE INVESTMENT CONTEXT

4.1 When we asked organisations to identify things that they valued but which did not appear in their balance sheets all of them came up with a range of things which they considered important. They described all sorts of factors that helped their organisations to succeed. In section 6 we categorise various areas deduced from information gathered during our interviews.

Commercial in confidence

4.2 As with tangible investment, resources will be limited and decisions need to be made on how best to allocate whatever resources might be available. With tangible investment the focus tends to be money but with intangibles it may instead be more about how people invest their time and brainpower.

4.3 We note that investing time in relationships, partnerships and networks can bring outside knowledge, expertise and even tangible assets to bear in solving problems and meeting the needs of customers. Business model design might, and in many cases should, include the use of partners.

4.4 Investing in intangibles tends to be about investing in new or enhanced capabilities, about becoming able to do things for others in better ways. Learning not just how to do something, but how to do it in such a way as to meet the needs of others. The quality of individual intangibles is important but it is the impression of quality of the overall package that creates value in the eyes of the customer.

4.5 While it is clear that the concept of investing to create value is well understood in the companies researched we have not found companies considering intangibles investment with the formality which is usually associated with decisions on investment in, say, new plant and equipment. Many of the intangible areas identified do not tend to feature in general investment appraisal process.

4.6 Some of the organisations studied would rather focus on the next job rather than invest in metrics to assess progress in this area. Between the organisations, there are, however, many examples where measures are used for specific aspects that are considered most important. In addition, a number of organisations have developed or are experimenting with more comprehensive tools to present a fuller picture of intangibles management which will help them to prioritise investment.

5 ANALYSIS OF PHASE 1

5.1 Categories of intangibles have been deduced empirically from the data gathered from visiting over forty organisations of varying sizes, many of which are growing strongly.

5.2 We have chosen to divide our material into three areas:-

- **Knowledge**
- **Relationships**
- **Key Multipliers**

5.3 We believe that dividing intangibles into areas is helpful in providing both focus and perspective. In order to preserve the wealth of ideas and diversity of thought, however, it remains essential to think in terms of connectivity between these areas as well as in considering practicalities such as: -

Winning resources; prioritising investment; gathering intelligence; making day to day tactical decisions; identifying vulnerabilities; reducing uncertainties; guarding against threats; and in enabling the organisation to understand and seize windows of opportunity.

6.1 KNOWLEDGE

6.1.1 All organisations use knowledge, we divide knowledge into three categories, codified, embedded and tacit.

6.1.2 Codified knowledge includes patents, designs, all forms of intellectual property, documented procedures, customer information in a database, product information and such like recorded in a corporate intranet or in brochures, technical specifications, pricing lists etc. Information that codifies the basis of contractual relationships or licenses. Information which governs actions, societies laws, accounting rules, trading standards etc.

Commercial in confidence

6.1.3 Embedded knowledge is similar to codified but tends to manifest itself within things that are used or produced as part of the value creation process, algorithms within a computer programme, the knowledge that goes into components or raw materials that you purchase or things that the organisation produces. Technical equipment might be viewed as material wrapped around knowledge.

6.1.4 Tacit knowledge, the knowledge that resides in peoples heads either as individuals or as groups of individuals, information not yet codified or too difficult to codify usually arising from experience, observation, study or from relationships with others. Understanding of “licence to operate”, in other words, how to get on with others who are important to your trading environment.

6.1.5 Sharing knowledge and collaborating is a key part of investing in relationships. It is the ability to gather, understand, use and re-use and share knowledge that enables leverage of the customer base.

Example Quote

“We gather intelligence from suppliers, machinery manufacturers, consultants and academics to understand better the trends and developments which will influence the development of products and services which meet customers’ needs”.

6.2 RELATIONSHIPS

6.2.1 All organisations have a wealth of relationships that need to be managed. The “hearts and minds” of employees must be in tune with communicated objectives and aspirations of the organisation. Suitable motivation and reward packages should be based on measurement of outcomes.

6.2.2 Internal relationships are just as important as external relationships. The need to work together, to supply the conditions necessary for success, gathering, sharing, using and re-using the knowledge and know how necessary to produce the products and services which end users pay for.

6.2.3 Internal and external relationships provide not just the deals, on which the organisation depends for cash generation, they also supply knowledge, understanding of the marketplace, ideas for new products, problems to solve and potential solutions to problems.

6.2.4 It is not just current relationships either, potential relationships, new customers and staff for example. Investing in those things that will attract and retain them. And relationships who have a legitimate interest in the business, those who can influence the ability of the organisation to operate, regulators, pressure groups and those who are touched by organisational activity.

Example Quotes

“Things like the concept of customers at risk are not included in the accounting model. When you start to think more about this type of issue you start to think more about things like client relationships and loyalty, these are things that you need to understand.”

“Relationships are our most important asset, the way employees interact, with each other, with suppliers, customers and joint ventures partners”.

6.3 KEY MULTIPLIERS

6.3.1 As previously mentioned we view the value of a business as the net present value of perceived future income streams. The problem lies in deciding what these future income streams will be. In this connection anything which helps to reduce uncertainties surrounding the expectation of achieving future income streams is valuable. In this section we deal with a number of groupings of intangibles which, being good at, may underpin results.

6.4 OPTIONS AND FLEXIBILITY TO CHANGE

6.4.1 Just as products and services have a “life cycle” so does the business model for each aspect of the business. Incremental and radical change is the norm for innovative business which takes advantage of rapidly evolving environments to seek out and evaluate and develop new value creating opportunities. Change requires investment and the portfolio of businesses we visited mentioned, not just the question of money, but of knowledge and time.

6.4.2 Winning resources is a key activity for both the organisation as a whole and for individual business units within the organisation. Whilst money for the organisation may be dependant on relationships with shareholders, bankers or those who provide credit, individual business units need to develop similar relationships to win resources internally. Knowledge might be shared, traded for or harvested from both within the organisation and through a wide variety of partnerships and networks. Use of time must be prioritised based on both short and longer term aspirations and whilst speaking of time, speed of execution may be of vital importance in winning business and markets.

Example Quotes

“If you are living in a world that is moving faster and faster then the inherent ability of an organisation to move quickly is something that we should be starting to measure. We are starting to understand the ingredients that make up change-friendly organisations”

6.5 PROCESSES AND SYSTEMS

6.5.1 This area represents the methods that allow value to be extracted from the tangible and intangible base. It includes both informal and institutionalised ‘processes’. These activities represent the leverage mechanism for knowledge and relationships.

6.5.2 Activities are diverse, for example; process of recruitment, of appraisal, training motivation and remuneration; processes of communication and reporting, both inside and outside the organisation; systems and processes for gathering, storing, and retrieving information; processes of research and development; relationship management process; risk management and analysis processes; innovation and design processes etc..

Example Quotes

“Do not assume that systems fix processes. They don’t. Processes must be sorted out on their own then systems come in to automate processes. Putting a system in will not fix a busted process. You have to fix the process first.”

“There is huge hidden value in understanding how to use processes, and failure to understand can destroy value”

6.6 SKILLS AND COMPETENCIES

6.6.1 This area covers the individuals’; the teams’ and organisations’ abilities needed to make appropriate use of the portfolio of company processes and systems to extract value from tangible and intangible resources. It includes the ability to innovate and adapt and grow the business. Virtually all the companies in the study recognise the value potential in building the abilities of their people and the ways in which the business makes best use of their various talents.

6.6.2 These are the intangibles that address the short and longer-term strategic goals of the company. They have the capacity to respond to leadership, and the framework it provides for taking decisions, dealing with conflicting priorities, breaking the rules in order to achieve strategic aims (‘doing the right thing vs. doing things right’).

Example Quotes

“What people fail to see in investing in soft skills in particular, is the commercial element. They think it’s soft fuzzy stuff. It is not. It is a hard, commercial decision. It is about building strategic capability into your business to win more business. It’s about making money.”

6.7 CULTURE AND VALUES

6.7.1 This area is concerned with ways of working, attitudes expected from those working in the organisation and the environment created to maximise the value creating potential of the organisation. Enhancing the image of the organisation, its likelihood of winning resources and business.

6.7.2 The view that the model of employee actions being driven by a set of explicit, bureaucratic rules, often under close supervision is outdated. In the modern economy this close control has to be replaced with something more responsive to change. Employees are expected to take responsibility and act swiftly, so building understanding of, and having empathy with, a clear set of values is a more sensible way to build the capacity to delegate decision making to where it matters.

Example Quotes

“We need to remove the “silo mentality” which destroys value and replace it with more open relationships between product areas and a joint commitment to corporate goals”.

“It was essential for employee motivation and satisfaction to know where the company was heading and how it planned to get there”

“Clarity about corporate values had become more important with the growth of the fast-moving knowledge economy”.

“Employees and customers want to feel good about their association with the organisation”.

6.8 REPUTATION AND TRUST

6.8.1 Consumer goods companies often invest huge sums in their brands because the standing of the brand with consumers determines its success. However, one company sounded a note of warning: do not mistake a ‘trapped customer’ for a ‘loyal customer’. Both may appear to act in the same way but a trapped customer will head for the exit as soon as an opportunity arises. Brand concrete, inability to change, can be an intangible liability.

6.8.2 Businesses that do not have consumer brands are increasingly recognising that their corporate brand, or reputation, can be equally significant.

- It may influence customer buying decisions
- It may also be the key to attracting top talent to work for the company
- It may be a company’s standing or reputation that determines whether they are selected as business partners.

Example Quotes

“Reputation is important. We are competing against others. We want to be seen as good people to work with. It helps us get into discussions early.”

“Trust is fundamental to making relationships work”.

6.9 NETWORKS AND PARTNERSHIPS

6.9.1 In the knowledge economy, few companies believe they have a monopoly of knowledge power to operate entirely independently of others. Many are therefore seeking to develop partnerships as a way to enhance operations and prospects.

6.9.2 Increasingly companies see suppliers, customers and networks both within and outside the business as an essential component of business success and influence. It is clear however that there are a wide variety of valued networks and partnership that have been established by the organisations we visited. Examples were found both on the buying and selling side, outsourcing of things like maintenance, particularly technology, links with academia etc.

Example Quotes

“High profile partners may help build reputation, options and enhance chances of doing deals with other potential partners”.

“Networks help to feed the systems and processes which make value creation possible. They feed in knowledge, fuel innovation and create the context for valuable relationships”.

“We aim to attract partners by understanding their needs better than rivals. Understanding each other’s needs may make it possible to structure deals that create more value for the both partners”.

“We entered this partnership to help with the defence of our IP, having this partner with us helps deter some that might otherwise see us as a soft target”.

7 CONCLUSIONS AND WAY FORWARD

7.1 Phase I of this project has provided a rich basis for identifying the territory that needs to be covered in understanding the value which resided in intangibles. We are conscious however that the multitude of quotations and stories provided during the first interviews were provided without the benefit of these consolidated findings.

7.2 This unpublished summary of Phase I is provided by way of initial feedback to each participant organisation, it also provides a basis for discussion and enrichment of findings during Phase II of this study.

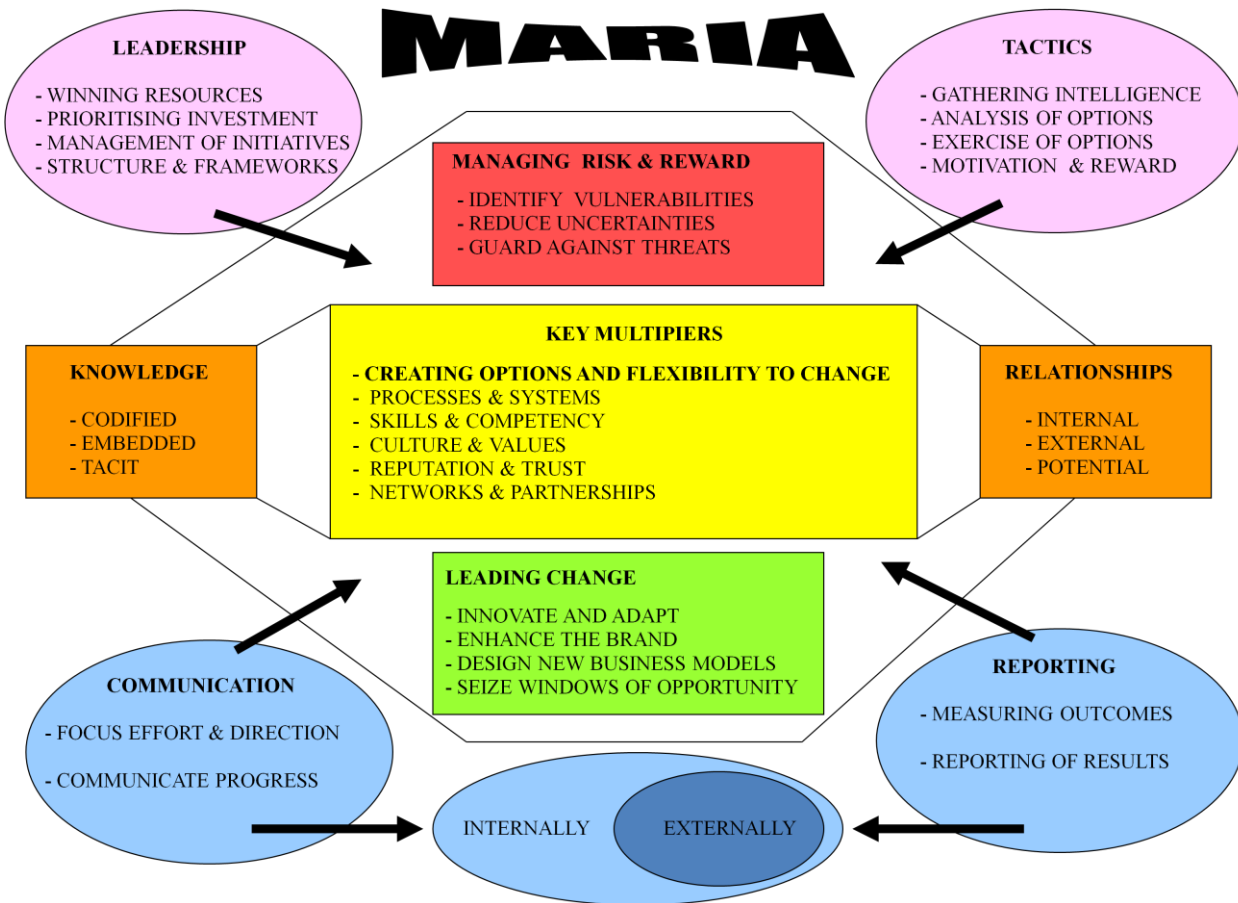
7.3 During Phase II our aims are to gather and or confirm the following: -

- Accredited quotations given either during the first interview or given now in response to this paper.
- Accredited case studies of not more than 200 words that might be used to provide an example to others of any initiative that demonstrates a successful investment in intangibles.
- Examples of things that are measured, and how measurement this is achieved, by each of you as part of your management processes in connection with any intangibles.

7.3 The final output will be a published report which will:

- Be aimed primarily at SME’s
- Be written in plain English
- Will highlight the link between Intangibles (valuable or important things not currently included within financial statements and value creation.

Schematic



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