

Taking Stock of Intellectual Capital

This is the second of Dr. Deborah Swallow's reports bringing life to the ideas behind knowledge management and intellectual capital

“Microsoft's market capitalisation is more than ten times the company's book value and Nokia's nearly six times. The wealth of high-tech companies like these does not consist only of machinery and equipment. The skills and talents of their personnel are likewise hugely important assets.”



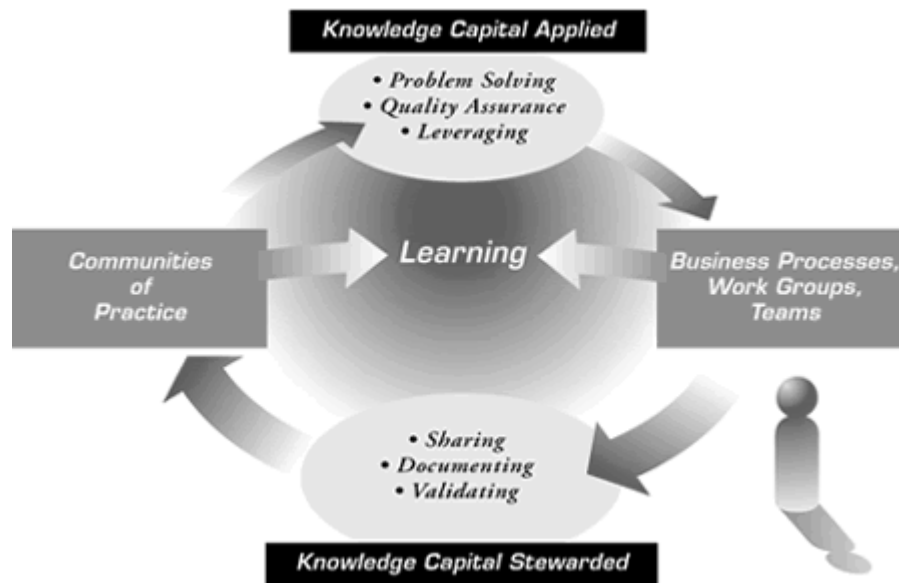
Surveying the corporate landscape will reveal that more companies are destroying knowledge assets than actively generating them, whilst others are consciously turning their intellectual assets into a competitive advantage. Our traditional accounting principles fail to account for knowledge in any meaningful way and is the key reason why the vital importance of valuing and managing knowledge is missed.

Over the past twenty years there has been a significant widening of the gap between the values of enterprises stated in corporate balance sheets and investors assessment of those values. Acquisitions of knowledge-intense companies often assess their value at more than ten times the book value. This distortion is leading to a growing concern about the relevance of orthodox financial reporting and disclosure to the modern economy.

Just at a time when the processes for fast, accurate and reliable audits has been perfected, the accountancy profession finds that the audit itself has been marginalised in mainstream business. Many authors are in agreement that traditional financial accounting is a retrospective and definitive process and scant attention is paid to it when valuing knowledge-intensive firms on the investment market. 'Intellectual Capital' as a measurement is creating, for the first time ever, the possibility of finding a universal yardstick for comparing value creation in diverse institutions, from banks and businesses to hospitals and councils.

Companies in the Nordic countries have been pioneers in this respect. In Sweden they have passed legislation requiring all companies with more than 100 employees to produce personnel balance sheets along with their financial statements each year. Denmark has undergone a huge study which demonstrates the positive growth effects that measuring and monitoring intangible assets has on its firms. Finland, too, is undergoing the process of developing personnel accounting systems. There is an EU-funded Meritum project, the aim of

which is to develop means of measuring companies' intangible assets, especially intellectual capital, so as to be able to understand their value and build on them.



A Two-Part Model

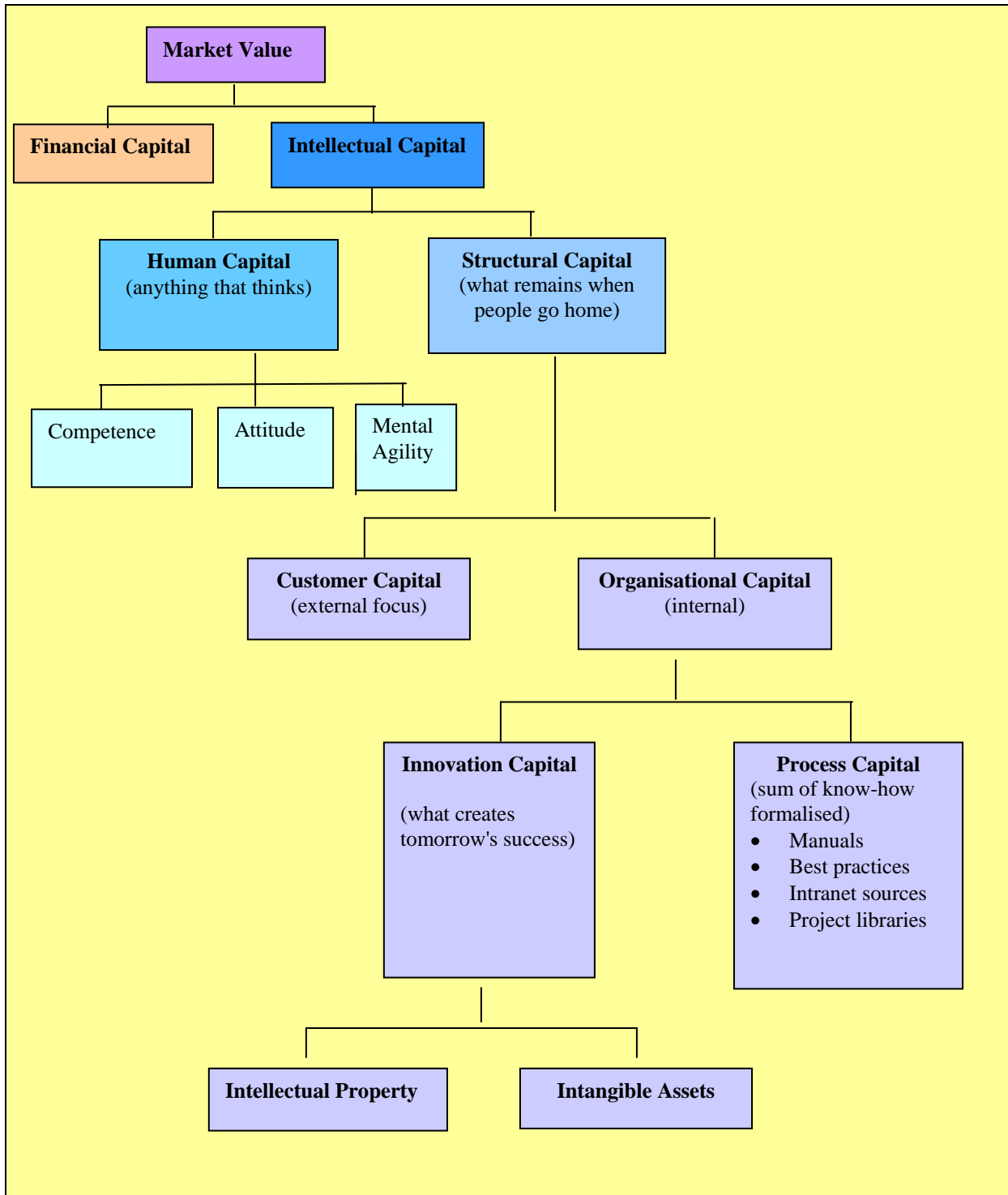
A simplistic view of organisations suggests Intellectual Capital can be divided into two parts; what walks out of the office at night and what remains when everyone goes home. In other words, a business owner has to ask the question, "How much is my business worth at 11am and how much is it worth at 8pm?" Clearly, if the business has a high asset value of capital goods, such as a factory with raw materials and work in progress, the difference between the two time zones will be small. However, if the people are the raw material of the company's value creation the difference will be large. In that instance, the business owner has to trust that the employees will return the next day.

Most management teams have no problem in coming up with a long list of intellectual capital indicators to measure but sometimes it is based more on hunches of what makes sense than on well-grounded theory. Before an IC index can be developed it is often necessary to refine the list of indicators and select from it the important few indicators of intellectual capital which can form the robust index that captures what it is intended to capture - what it is that makes the business a real success.

Developing Intellectual Assets

A firm must devise an agenda for transforming from an organisation simply comprising knowledgeable individuals to a knowledge focused organisation. A company's business concept, its ideas and resources combine to form a dynamic totality that is constantly evolving. This agenda comprises many elements – people, incentives, technology, processes,

etc that need to be drawn together carefully to fit in with the strategic aims of the organisation, its culture, capabilities and resources.



Generally knowledge management includes practices for knowledge and each of these practices might be implemented in a different way according to the degree of formality, technology and systems there are in an organisation.:-

- Creation (learning) and destruction (unlearning)
- Acquisition (purchase) and disposal (sale)
- Testing, accessing and sharing
- Storage, conservation and protection
- Allocation and application
- Integration and transformation

The aims and benefits of knowledge management are diverse:



- Improvements in organisational creativity, effectiveness and performance
- Reduction of business risks
- Better planning of organisational restructuring and downsizing
- Support for R&D, new product development and process improvement
- Development and growth of new core competencies
- More effective use of IT
- Better human resource management and incentive schemes for knowledge workers

The Pursuit of Measurability and Valuation

Generally there seems to have been two parallel streams of research. Some scholars have endeavoured to come up with a way of valuing financially the hidden assets of an organisation so as to signify to the market its hidden value creation process. They have worked on an IC audit and an 'alternative' balance sheet. Others have focussed on the knowledge-based view for the daily management of companies and on precisely what to measure. Thus, they have taken the view that 'what you measure you can manage'.

However, there is still much debate on the approach that should be taken in the construction of an IC audit. Only through the use of a balance scorecard and a profit and loss approach to IC can meaningful measures like return on intellectual capital be developed. A scorecard of multiple measures would monitor growth or decline in IC value, and help solve the problem of choice between two or more strategic decisions by making "uncertain and subjective feelings more visible".

A distinction can be drawn between intellectual capital (as a value) and intellectual performance (as a measure of efficiency). Thus, by combining both the valuation of

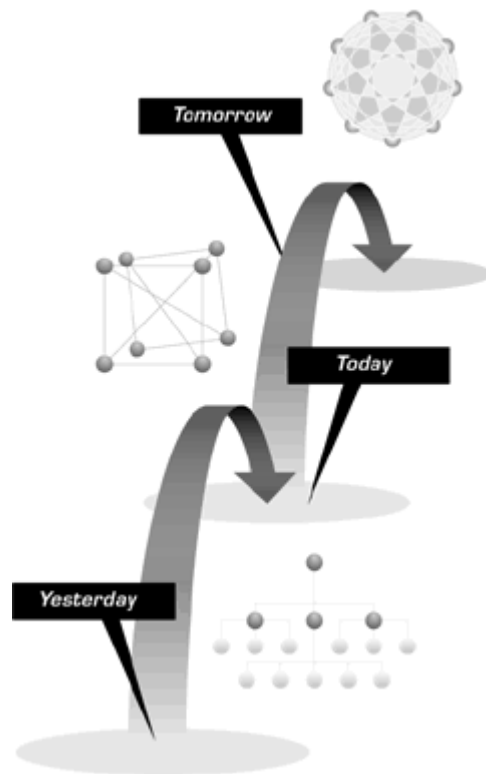
intellectual capital with performance measurements an organisation can monitor on a continuous basis the growth/decline of its intellectual capital. This takes the concept of intellectual capital into the realms of continuous improvement. The results of this monitoring are increasingly interpreted as an early warning signal of subsequent financial performance because they say more about future earnings capabilities.

Where Do We Go From Here?

A common understanding underpins financially driven approaches to resource allocation – that is they are seen as limited in supply and once allocated may not be available for reuse elsewhere. However, it can be argued that knowledge-intensive companies might actually follow a different economic law: the law of increasing returns. The great thing about knowledge is if you share it, you have not lost it; you have still got it and probably just made more of it!

Establishing a reporting system and putting into place the right technology to process it will not be simple, even with the help of new applications programs. IC reporting will also require a mindset change of those who administer it. For those very smart and dynamic companies IC measurements will be not only for the outside world but also for the company to better understand and enhance itself.

Smart, successful companies will recognise that IC reporting gives them a competitive advantage when it comes to valuation, and therefore they will jump on the bandwagon. Accountants will have a new role to play in supporting the creation of these new accounting methods. Those companies that try to resist, for whatever reasons, will look secretive in a modern world of virtual corporations that demands openness and the sharing of once proprietary information. They will instantly be at a disadvantage in the investment market.



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