



## Measuring the Immeasurable: Intellectual Capital (Part 1)

### Success Factors

Personal and corporate knowledge (information + experience), how it is used and how it flows within and across an organization, is a critical discriminator that can help a company establish competitive advantage in the marketplace.

Knowledge is a key organizational resource that can be more valuable and more powerful than other natural and capital assets. Many high performing, knowledge enabled organizations understand that the ability to leverage “what they know about what they do” and then are able to “create value from their knowledge” will outperform those that don’t. They are able to leverage their **Intellectual Capital** (IC) at the individual, team, unit and organizational levels. Unlike the ‘classical’ assets with which people are familiar, IC is intangible. It is about the knowledge of a workforce, their training and the learning, both explicit and tacit that is key.



It is collaboration – the shared learning – between an organization and its customers and partners, establishing a trusting relationship, that helps bring the customers back. IC is intellectual material – knowledge (information + experience), intellectual property – that can be used to create wealth and return value to the company’s shareholders.

Management research and consultancy services have traditionally focused on how to increase the efficiency and effectiveness of a company while ignoring the value of knowledge capture, processing and creation, retention, and access for reuse.

### Knowledge Creation, Goodwill and Company Value

Knowledge creation is the capability of a company at all levels to create new knowledge, to address new challenges and develop better solutions to challenges they face, and to make this knowledge searchable, findable, accessible and reusable. It embodies among many things products, services and systems. It is through the ongoing use of knowledge as part of day to day work that supports continuous innovation and creates competitive advantage.

The value of a company is often measured solely by physical, tangible and financial capital (assets) which a company finds in their financial statements. Sometimes considered are the intangible assets of a company which are often described as “goodwill.”

However, “goodwill” does not fully capture the real value of IC. Sometimes IC is interpreted as

the difference between the book value – i.e. the historic value of the assets of a company not yet amortized – and the market value, which equals the perceived, present value of the future cash flow of a company.

In reality, a company's IC is more accurately described as the sum of its human capital (talent), structural capital (intellectual properties, methodologies, software, documents and other knowledge artifacts), and customer capital (client relationships). These intangible assets or IC are a lot about relationships with customers, suppliers, partners and employees.

The Swedish financial services company Skandia illustrated this new approach in 1995 when they published the world's first IC annual report. Skandia was able to quantify their intangible assets – IC – and by doing this they increased the awareness of the IC concept in Europe.

### **Importance of Determining the Value of IC**

The lack of a robust means to determine the IC value of an investment opportunity often makes such investment decisions risky. A company with a large IC value, outside the scope of traditional accounting principles, and with high future earnings potential, can easily be undervalued. The consequences may be undercapitalization and reduced ability for the company to perform and grow.

Measuring IC generates not only great interest but also some skepticism. Corporate financial statements may be cluttered with “good will,” restructuring charges and other items that companies complain no longer describe financial performance clearly or fairly. Is it wrong to mix measures of IC with financial data - or is it a greater mistake not to estimate and present IC at all?

Managing IC depends on finding credible ways to track it. IC measurement should allow management to evaluate year on year performance – indicating progress towards goals – and, second but more difficult, permit company-to-company comparisons. Undoubtedly measuring knowledge assets may be imprecise, but there is a lot of informed guesswork in “hard” numbers, too.

### **Measuring IC and Company Value**

A very simple measure of IC is the difference between its market value and its book equity. The assumption here is that everything left in the market value after accounting for the fixed assets must be intangible assets. But focusing on “market-to-book” ratios has three problems:

1. The Stock market is volatile and responds strongly to factors outside management control.
2. There is evidence that both book value and market value are often understated.
3. Stating that a company has billions in intangible assets, the “so what” question arises. What can I, as a manager or investor, do with this information?

The accounting community is struggling with reducing relevance of traditional financial information and is working on ways to recognize intangible assets. The International Accounting Standard Committee, IASC, recognizes that investments in, and awareness of, the importance of intangible assets has increased significantly in the last couple of decades. It has worked for almost 10 years to produce International Accounting Standards on Intangible Assets.

Using financial assets to determine a company's market value is becoming of less importance while non-financial (intangible) assets are becoming important drivers of performance and market value. There exist to date little or no objective quantitative measures of intangible assets. Where they are claimed to exist (e.g. valuation of brands, intellectual property, patents) they are very specific and scope-limited.

Researchers have recently been developing models and formulas for identifying and quantifying intangibles as components of IC. These models serve to evaluate a company's return on all the capital it employs, helping to explain the difference between book and market value. They also help to indicate where management should focus its attention to develop the organization's IC.

### **Other Business Factors**

Partnerships, alliances and networks are increasingly critical factors in business success. It is important to note that much of IC is made up of shared capital. For example, Human Capital (HC) is shared with its 'owners.' When an employee leaves a company, the employee takes their skills, expertise, competencies (their knowledge) with them. Organizations that have frameworks to capture employee knowledge as part of normal operations will be able to mitigate this risk. Should companies that have the ability to capture and reuse knowledge as part of the way they work be valued more highly? Similarly, should those that don't invest in Knowledge Management (KM) concepts, strategies, and practices have a lower valuation?

Similar rules apply to Customer Capital (CC) and Strategic Alliance Capital (SAC). At least the customers' name remains on the company's reference list, and a former partner may still perform as an 'at arm's length' supplier showing that some CC and SAC has become structural not affected by the departure of a customer, strategic alliance. It is important for company management to understand where their IC is located, and consequently which actions need to be taken to manage it effectively.

In the Nordic countries especially, national governments have produced legislation to force private organizations to make public some IC items. The European Commission invests heavily in the research and promotion of IC, which, in the near future, will hopefully result in some general rules and instructions for the economic community to start reporting their intellectual assets next to the traditional financial values.

Isn't it time to determine how to value all the assets of a company and how to use this valuation in determining overall company value? Is this not also a measure of performance and performance capability?

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