

Counting What Matters

Pamela Holloway, AboutPeople, Inc.

More than three quarters of the market value of today's most successful companies is built upon intangible sources of value including people, knowledge, innovation, and relationships with customers, suppliers and employees. These assets may not appear on the balance sheet but you can bet they play a key role in the creation of value for your organization.

Here are some examples. A 1999 study by Arthur Andersen found that a minority of companies were responsible for creating a disproportionate share of value. They found that 71% of the publicly traded companies surveyed had below average returns for 1978 to 1996. The remaining 29% raised the average for all. The more successful companies, in particular, those in the top 10%, were dramatically and disproportionately more efficient at leveraging assets that were not on their books (i.e. the intangible ones).

Similar examples were produced in work by Lev Baruch. Baruch found that Microsoft had knowledge assets worth 221 billion, Intel 170 million and Merck 110 billion. Compare those to Dupont with more employees than all of those companies combined. Yet Dupont's knowledge assets total only 41 billion.

Other examples of value produced from intangibles include Coca-Cola's immense brand value worth \$60 billion and Dell's unique way of doing business - what Baruch calls "Structural capital" which totals 86 billion, higher than that of Wal-Mart.

Intrinsic Versus Book Value

In his *User's Manual for Stockholders*, Warren Buffett draws the distinction between intrinsic value and book value using a college education as an example.

The intrinsic economic value of the education is represented by the extra earnings the student will receive because of her degree, minus the income she should have generated had she gone to work instead of school for four years. If the graduate flunks out, book value may end up exceeding intrinsic value; otherwise, intrinsic value will be far greater. Either way, Buffett says, Book value is meaningless as an indicator of intrinsic value."

Another great example is AMR, parent company of American Airlines, who derives 50% of its value, not from flying airplanes, but from their SABRE reservation system.

Think about it. One of the largest airlines in the world with 700 jets, nearly 100,000 employees and exclusive and valuable landing rights in the world's most heavily

trafficked airports derives half its value (probably more now) from a computer system. Exactly what makes this computer system so valuable?

The answer lies in asset "leveragability." When you're dealing with tangible assets, your ability to leverage them, to get additional business value out of them, is limited. You can't use

the same airplane on 5 different routes at one time. And the same goes for the financial investments you've made in the airplane. But there's no limit to the number of people that can use AMR's SABRE system at once.

Realizing the Value

Almost everyone would agree that intangible assets are valuable, and in many cases they are more valuable than their tangible counterparts. In order to realize the value of these intangible assets however, it is essential that we develop ways to effectively measure and manage them.

Easier said than done, right? Both companies and analysts continue to struggle with the problem of measuring intangible assets. Part of the problem is that we continue to try to account for intangibles using a 500-year-old accounting system based on transactions.

“Sometimes what counts can't be counted, and what can be counted doesn't count.”

-- Albert Einstein

Pacioli's accounting system held up pretty well over the years, but it is no longer suitable for situations where value is created without producing transactions. For example, when a drug passes clinical trials, or software passes a beta test, value is created – but there's no transaction. Nothing changes hands. Nobody buys anything and nobody sells anything.

Another inherent problem with traditional accounting is the income statement and its categories of expenses. Income statements typically categorize many of the most significant sources of value – people for example, and training, and brand development, as expenses. Income statements also overlook much of the value derived from customer relationships and information.

At the same time, many of the things regarded as assets and included on income statements as assets (buildings, equipment, etc.) should now be classified and treated as expenses.

Three Ways to Approach Valuation of Intellectual Assets

There are a number of methods in use today for valuing intangible and intellectual assets. They typically fall into one of these three types of measures:

1. **Absolute Measures:** Assign a quantifiable dollar figure for the market value, user utility or replacement value of intellectual capital assets. Drawback: measures don't provide useful detail.
2. **Relative Measures:** Quantify indicators and progress toward a goal. Swedish financial services firm Skandia uses up to 150 indicators for measurement of intellectual assets. Drawback: No direct correlation to business results.
3. **Supplemental Measures:** Stay with current financial reporting and add absolute and relative calibrations as auxiliary information. Drawback: Doesn't solve underlying problem.

(Source: Imperfect Measures Are Better than None. Knowledge Management Magazine.

What to Count: Baruch Lev's Categories of Intellectual Assets

Baruch Lev uses these three categorizations for intellectual assets:

1. Assets associated with product innovation, such as those that come from a company's R&D efforts
2. Assets that are associated with a company's brand, which let a company sell its products and services at a higher price than its competitors
3. Structural assets – smarter, different ways of doing business that can set a company apart from its customers

The Portfolio Concept

We know that a company's value is made up of both tangible and intangible assets. In the tangible category, we have things like buildings, equipment, cash, investments and market share. In the intangible category, we have things like intellectual capital, culture, strategies, brand, and relationships.

The best way to increase your company's value is to take into consideration the full range of assets, in other words, take a more holistic approach and focus on your company's Asset Portfolio.

Managing your business portfolio is much like managing your personal investment portfolio. You make decisions based on specific needs (putting your kids through college, early retirement, etc.) and according to your risk tolerance.

Much like your personal investment portfolio is made up of a combination of assets including stocks, bonds, mutual funds, real estate, etc., your business portfolio is made up of categories of assets: Customer, Employee & Supplier, Financial, Physical and Organization. Value is created by assembling unique combinations of these assets.

The "portfolio" is essentially your business model. All management strategies, then become asset-portfolio strategies, designed to highlight and improve the value of specific assets as they interact and enhance the value of your business as a whole.

Step 1: Identifying Assets

The first step in the Valuation process is the identification of assets - both tangible and intangible.

1. What are your company's most important assets, both tangible and intangible and where are they located?
2. How much does your company invest in intangible assets and new technologies? Is this enough given the increasing importance of intangibles?
3. Is your company able to measure the value of intangible assets?

Asset Categories

The Value Dynamics Framework (From *Cracking the Value Code*¹)

Value Dynamics Framework



Customer Assets

Customer Assets encompass a company's customer and buyer base, plus its out-bound distribution channels and partners.

Customer assets include such factors as number of active customers, customer loyalty, market share, brand, competition, customer contracts, order backlog, sales cycle, distribution channels (sales intermediaries) and out-bound partners (sales catalysts).

Employee & Supplier Assets

A company's human resources and in-bound supply chain partners make up the human assets of an organization.

These assets include the company's workforce (employees, contractors, consultants, subcontractors and other labor), level of workforce knowledge, experience and expertise, effectiveness of compensation, and in-bound partnership strength and alignment (supply chain/alliance partners).

Financial Assets

Essential to a company's financial assets is its financial status and those items that reflect its credit and investment worthiness along with the company's other abilities to attract funds.

Financial assets also include items such as the company's cash position, cash flow, investments, debt, equity, economic performance of financial products, and availability and access of funds.

Physical Assets

These assets are an organization's property, plant, equipment, inventory (both supplies/materials and finished goods) and its other physical materials.

Measuring physical assets also includes such factors as real estate, productive capacity (owned or not), technological capability of plant and equipment, and inventory distribution. Physical location is also a key factor in valuing physical assets.

Organizational Assets

These assets encompass both the organizational and structural assets of the organization. These assets are visible in the ability and effectiveness of the strategy, culture, values, organization, authorities, control, business plan and compensation schemes.

Structural assets include the organization's know-how, procedures, processes, information systems, communication systems, innovation, inventions, products and service offerings.

References

¹ *Cracking the Value Code. How Successful Businesses are Creating Wealth in the New Economy.* Richard E.S. Boulton, Barry D. Libert and Steve M. Samek. © 2000 Arthur Andersen.

² *New Math for a New Economy.* Alan Webber. *Fast Company.* January-February 2000.

³ *Imperfect Measures Are Better than None.* *Knowledge Management Magazine.* November 1998.