Intangible Assets as a Framework for Sustainable Value Creation

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July 2015

Introduction

To become and remain successful, companies have come to understand that they need to follow a strategy of seek sustainable value creation. As a recent report notes, "Sustainable Value Creation is a core business strategy focused on addressing fundamental societal issues by identifying new, scalable sources of competitive advantage that generate measurable profit and community benefit." The ultimate goal is for the company to achieve growth and high performance.

Intangibles are key value creating assets that need to be developed and utilized in order to achieve growth—and to successfully implement a strategy of sustainable value creation. Every CEO knows that their company relies heavily on its people, its processes and its relations with the outside world. According to The Conference Board 2014 CEO Challenge survey, Human Capital, Customer Relationships, Innovation, Operation Excellence and Corporate Brand and Reputation are the top 5 challenges identified by CEOs. The concept of intangible assets links together this intuitive understanding by successful CEOs with a framework for analysis and decision making.

These assets are called by many names: intangible assets, intellectual capital, knowledge capital, knowledge-based assets, and intangible capital. They all basically refer to the same thing: organizations' non-physical assets. They include, for example, workforce skills and know-how, effective management and marketing, business models, relations with suppliers

* This paper was originally commissioned by The Conference Board for their use. It is published here in a slightly modified version with their permission. The author would like to thank The Conference Board for their financial support.
and customers, and software and databases as well as traditional intellectual property (patents, copyrights, and trademarks).

Every industry is now part of the intangible economy. Even property-intensive sectors such as real estate and oil & gas have high level of intangible assets. So do labor-intensive sector such as construction and retail trade. Already business investment in intangible assets is now greater than in tangible assets, such a buildings and equipment.

Rising U.S. non-farm business investment in intangible assets (% of output)

![Graph showing the rising U.S. non-farm business investment in intangible assets.](image)


Estimates are that on average 84% of company value consists of intangible assets.

![Chart showing the components of S&P 500 market value.](image)

As former Federal Reserve Chairman Ben Bernanke has said, the topics of innovation and intangible capital “are central to understanding how we can best promote robust economic growth in the long run.”

These are the assets which CEO's need to measure, manage and monetize.

But current accounting and measurement practices misrepresent the nature and extent of intangibles in the modern organization. Current management practices contain many vestiges of the top-down approaches that were used to optimize industrial organizations rather than optimize growth and performance based on intangible capital. Financial markets fail to understand and incorporate the value of intangibles and companies fail to build successful revenue strategies on their intangible assets.

These failures stem from a lack of understanding. Most CEOs don't have the information about these knowledge-based assets they need to make sound business decisions. In 2007, business executives and corporate boards admitted in a survey by Deloitte that too many of their decisions are being made “in the dark.” The situation is little better today. But there is now an additional and different problem. While there is growing awareness of the importance of intangible assets, there are a variety of perspectives.

Each perspective has its own use within an organization. All derive from a shared concern: what is measured is managed. And what is invisible does not get taken into account in decision making. This truism of management applies even if the measurement is only at the
most basic level of identification. Every manager needs to at least identify their assets, if not precisely measure them.

But the several possible measures give rise to confusion over what exactly the CEO should be paying attention to. Given the importance of intangibles to corporate performance, CEO's need to understand the multiple ways of approaching these assets.

Overview of the Frameworks

There are five differing approaches and frameworks highlighted in this survey:

- Accounting framework -- financial control
- C-H-S framework -- macroeconomic growth accounting/theory, including productivity
- Integrated reporting -- corporate reporting
- Sustainable Accounting Standards
- ICounts -- management
- OECD Knowledge-based assets -- public policy

Developed over the centuries, the accounting framework attempts to treat intangible assets as the same as tangible assets. These assets are specifically valued and placed on the corporation's balance sheet and subject to standard rules of accounting treatment of an asset. Since these rules generally require arms-length transactions and a strict definition of an "asset," this framework is limited as to what is included (see Appendix Figure 1). Internally generated intangibles are treated as expenses not assets while the same intangibles (for example, patents) acquired externally are treated as assets not expenses. Other intangibles, such as the value of the workforce, are never treated as assets. This framework is important for financial control purposes. However, given the difficulties of precise valuation and asset definition (recognition), the value of externally acquired intangible assets is often simply lumped into the general category of "goodwill."

Two offshoots of the accounting approach are financial analysis models and value-driver models. Financial analysis models seek to quantify the specific monetary impact of an asset, tangible or intangible. Return-on-investment (ROI) models are the most common version. Value driver models seek a systemic approach to link resource allocations (i.e. investments) to corporate performance, including financial performance. Most of these models use key performance indicators (KPIs), such as employee turnover and sales per employee, as well a financial outcome measures, such as profits. The extent these models don't fall victim to attempts at false precision, they can be useful for strategic management.

The Corrado-Hulten- Sichel (C-H-S) framework (see Appendix Figure 2) is a variation of the macroeconomic growth accounting model which is used to derive the contribution of investments in intangible asset to GDP and productivity. The Conference Board worked with Hulten to apply this approach at the micro level. In essence, this approach it corrects the
existing macroeconomic statistical tools by treating intangibles as an investment rather than a cost - thereby giving a more accurate picture of the economy. The framework is valuable in understanding the macro-economy and aligning that understanding with business growth.

**Integrated Reporting** seeks to overcome some of the problems associated with the traditional accounting framework. The framework goes beyond financial reporting to include tangible, intangible and environmental assets (see Appendix Figure 3). This framework is important both for management (internal) and stakeholder communications (external) purposes. It does not, however, attempt to expand financial reporting (i.e. accounting) of intangibles. Integrated Reporting is a tool for strengthen corporate governance by improving internal controls and risk management, enhancing oversight of senior management and strategy by the Board, and increase transparency. However, as currently constituted, it provides no cross-firm comparisons. Unlike standard accounting measures, each report is unique to the specific organization.

A more specific version of reporting somewhere between the traditional accounting framework and <IR> is the Sustainability Accounting Standards Board. This group is attempting to develop cross-firm comparable standards as to what information must be disclosed in company reports. These standards will cover the types of non-financial information companies must report on environmental, social and governance performance issues. As such, similar to <IR>, they improve investor information and corporate transparency.

The ICounts is a variation on earlier intellectual capital models and on the value creation models (see Appendix Figure 4). However, unlike earlier value creation models attempts specific financial measures, this framework seeks to identify an organization's intangible capitals and understand their role in creating and sustaining economic value. Key to the operation of ICounts is stakeholder engagement. Rather than simply rely on an internal view of the company, the process explicitly incorporates information and perspectives from both internal and external stakeholders. This model is specifically designed for management purposes.

In both the <IR> and ICounts frameworks, key performance indicators (KPI) are part of the model. Note that the ICounts framework can fit inside the <IR> framework as covering the intellectual, human and social capital component of the <IR> model in a slightly different structure (see Appendix Figure 5).

A somewhat different approach has been taken by the OECD policy framework. Not really an integrated model, the knowledge-based assets approach looks to elucidate the public policy issues associated with the investment in and the utilization of intangibles (see Appendix Figure 6).
Organizational Uses of the Frameworks

Different parts of an organization will utilize different frameworks. CEOs need to understand how various parts and functions within the organization look at and talk about intangibles. Otherwise, what the CEO will see will be a cacophony of concepts that will more resemble noise than information.

CFO’s and the accounting/financial staff will naturally gravitate to the established accounting frameworks. Lawyers tend to see intangibles as a form of contractual rights and obligations. As the accounting framework specifically treats intangibles as owned and controlled by the organization, this framework is generally useful to both lawyers and accountants.

Business managers see intangibles in operational terms: what resources are needed to undertake a particular activity; where do those resources come from; and what is the most effective deployment of those resources. These operational managers are likely to find the ICounts framework the most valuable.

Risk managers have their own very defined subset of issues to look at: ethics, compliance, governance, assurance, operational risks and security, and reputation. They will tend to look at portions of ICounts-type frameworks. Note that those lawyers with responsibility liability issues would also tend to see intangibles in this broader framework.
Investors see intangibles as a bundle of attributes of a company. Their concern is that these attributes may or may be disclosed. The <IR> framework specifically addresses investors’ concerns.

Government officials and policymakers see intangibles in terms policies and incentives for the creation and utilization of those intangibles, such as education and workforce in general; the OECD framework may be most useful to them.

Those who advise companies on economic matters, including economic forecasting should look to the C-H-S framework to better understand the working of the economy. Economic policymakers who see intangibles as factors of production in macroeconomics will also find value in the C-H-S framework.

**Using the Frameworks in Sustainable Value Creation**

As has been noted, a strategy of sustainable value creation requires firms to recognize opportunities and "recalibrate their radar." Importantly, this process of assessing outside opportunities must be married to a process for assessing the capabilities and competencies. It also requires a greater understanding of the external environment. Using an intangible assets framework can help with both points—directly and indirectly.

Specifically, intangible assets frameworks can be used to directly address the capabilities question. After all, the heart of the question is "do we have the assets/resources we need to exploit the opportunities?" The ICounts framework, for example, utilizes a series of assessment questions about a company's intangible assets to address that issue on each of the four types of intangible capital:

- **Human Capital**: are the competencies and skills of both management and employees at the level needed to exploit the opportunities;
- **Structural Capital**: are our marketing/sales capabilities, and knowledge & IP assets adequate;
- **Relationship Capital**: do we have the needed relations with customers and partners and are our brands in line with our strategy; and,
- **Strategic Capital**: do our business models match the opportunities and do we have an adequate understanding of external factors?

Note at in a full assessment, each of these areas would be the subject of much more detailed questions and analysis.

Note also that understanding of external factors is a component of Strategic Capital. The framework therefore provides a means of assessing the company's ability to recognize opportunities and maneuver in the local context to respond to those opportunities.

In addition, the framework has an indirect impact on a company's ability for understanding the external environment. Relationships with the external world (beyond customers and
suppliers) are a key intangible asset—both as transactional activities and for setting the environmental context. The frameworks raise the visibility of these relationships by treating them as assets and investments, with financial commitments and consequences. When these relationships are seen as valuable for both financial and non-financial reasons, more attention is paid to them. It is a subtle shift in perception—but one that can have far ranging consequences.

Conclusion

Following a strategy of Sustainable Value Creation allows companies to recognize and focus in on market-based opportunities that benefits both the companies’ bottom-line and addresses urgent social needs. Development and utilization of intangible assets is required to exploit those opportunities. With 84% of companies' value being found in their intangible assets and more of a country’s investment going into intangible rather than tangible assets, CEOs need to understand and be able to manage those assets. There are multiple frameworks for describing intangibles. CEOs need to both understand how various parts of the organization look at and talk about intangibles. And they need to understand how an assessment of intangible assets is really an assessment of the organization itself—a needed activity for the implementation of a strategic vision.

While the different frameworks have different uses, an overall high-level conceptualization is needed to guide CEO thinking. That high-level archetype might best start with an integration of the <IR> and ICounts frameworks and weave in the C-H-S framework (for understanding inputs and macroeconomic affects) and expanded accounting models (for financial controls). Putting together such a high-level view that operates with the more specific models would be a useful undertaking. For a CEO’s perspective, it would be a valuable tool in creating and implementing a strategy of sustainable value creation.
Appendix

Figure 1: FASB List of Intangibles

a. Marketing-related intangible assets
   (1) Trademarks, trade names, service marks, collective marks, certification marks
   (2) Trade dress (unique color, shape or package design)
   (3) Newspaper mastheads
   (4) Internet domain names
   (5) Noncompetition agreements

b. Customer-related intangible assets
   (1) Customer lists
   (2) Order or production backlog
   (3) Customer contracts and related customer relationships
   (4) Noncontractual customer relationships

c. Artistic-related intangible assets
   (1) Plays, operas, ballets
   (2) Books, magazines, newspapers, other literary works
   (3) Musical works such as compositions, song lyrics, advertising jingles
   (4) Pictures, photographs
   (5) Video and audiovisual material, including motion pictures or films, music videos, television programs

d. Contract-based intangible assets
   (1) Licensing, royalty, standstill agreements
   (2) Advertising, construction, management, service or supply contracts
   (3) Lease agreements
   (4) Construction permits
   (5) Franchise agreements
   (6) Operating and broadcast rights
   (7) Servicing contracts such as mortgage servicing contracts
   (8) Employment contracts
   (9) Use rights such as drilling, water, air, mineral, timber cutting, and route authorities

e. Technology-based intangible assets
   (1) Patented technology
   (2) Computer software and mask works
   (3) Unpatented technology
   (4) Databases, including title plants
   (5) Trade secrets, such as secret formulas, processes, recipes.

Figure 2: Corrado, Hulten, and Sichel (C-H-S) framework

<table>
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<tr>
<th>Broad category</th>
<th>Type of Investment</th>
<th>Type of Capital</th>
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| Computerized Information | • Software development  
  • Database development | IPRs/Codified knowledge |
| Innovative Property | • R&D  
  • Mineral exploration  
  • Copyright development (artistic original)  
  • Design and other product development costs | Forms of IPRs:  
  • Patent  
  • License  
  • Copyright  
  • Design IPR  
  • Trademark |
| Economic Competencies | • Market research & advertising  
  • Business process investment  
  • Training & skill development | Organizational |

Figure 3: <IR> Framework of 6 Capitals

Figure 4: ICounts Framework

Employees collaborating together and with external partners to create re-usable knowledge, designs and processes that meet market needs via a viable business model.

Figure 5: ICOUNTS and <IR>

Figure 6: OECD Policy Areas

1. Knowledge-based capital, innovation and resource allocation
2. Taxation and knowledge-based capital
3. Competition policy and knowledge-based capital
4. Measuring knowledge-based capital
5. Knowledge-based capital and upgrading in global value chains
6. Knowledge networks and markets
7. Corporate reporting and knowledge-based capital
8. Exploring data-driven innovation as a new source of growth: Mapping the policy issues raised by “big data”

http://dx.doi.org/10.1787/9789264193307-en
Notes


8 In the Dark II: What many boards and executives STILL don't know about the health of their businesses, a survey by Deloitte in cooperation with the Economist Intelligence Unit, 2007, http://bit.ly/1HifXa2
