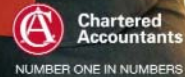


NSW Business Forum 2007

Intangible value: the hidden assets

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Sarah Hatcher, CEO, Society for Knowledge Economics

charteredaccountants.com.au/training



Intangible Value – The Hidden Assets

1. **Drivers of change** – why are intangibles increasingly important?
2. **International trends and developments** – what are some of the responses and possible solutions?
3. **Effects of measurement and reporting** – what are some of the benefits and challenges to organisations and other stakeholders incl. capital markets
4. **How might the future look?**



1. Drivers of Change

– why are intangibles increasingly important?



Drivers of Change

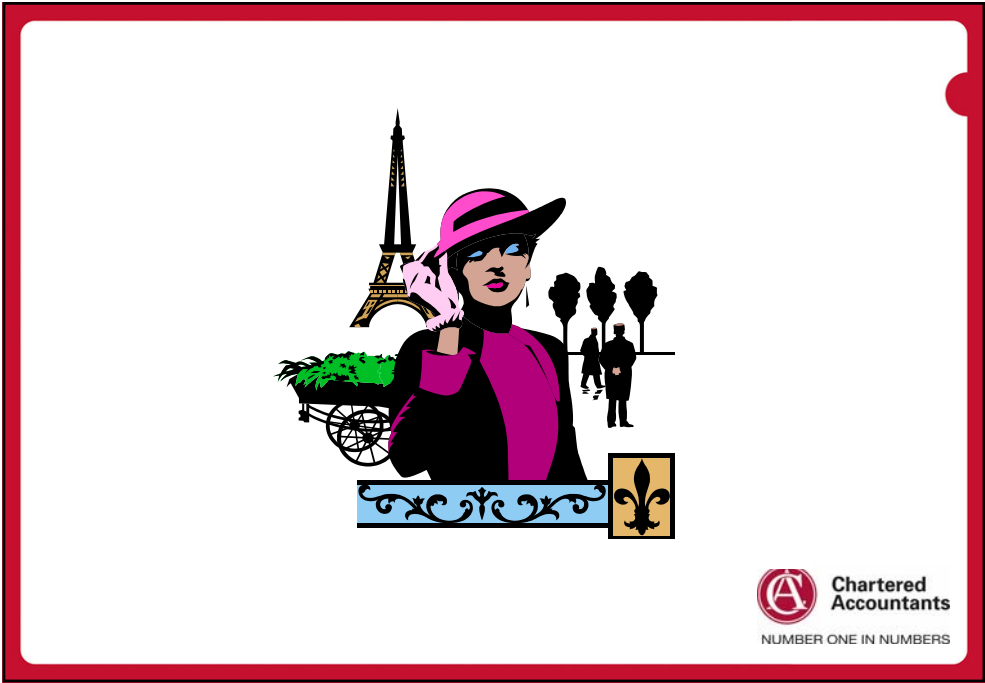
A. Accounting Limitations

B. The Rise of the Knowledge Economy

C. New Business Models

D. Intangibles as a Source of Competitive Advantage





A: Accounting Limitations

How does the BS help internal and external stakeholders make better decisions about intangible resources and the 'invisible' drivers of company performance?

Intangibles featured on BS include among others IP, acquired brands and customer lists.... But many intangibles do not meet the Accounting Standard's recognition criteria.

(All Figures in USD)			
Assets	2001	Liabilities and Owners' Equity	2001
Current Assets	5,000,000	Current Liabilities	
Cash	500,000	Accounts Payable	4,000,000
T-Bills	1,000,000	Dividend Payable	2,000,000
Accounts Receivable	7,000,000	Taxes Payable	3,000,000
Total Current Assets	13,500,000	Total Current Liabilities	9,000,000
Inventory		Long-term Liabilities	
Raw Materials	825,000	Long-term Bank Loan	5,000,000
WIP	750,000	Total Liabilities	14,000,000
Finished Goods	1,200,000	Owners' Equity	
Total Inventory	2,775,000	Capital	20,000,000
Long-term assets		Retained Earnings	28,275,000
Land	30,000,000	Total Net Worth	48,275,000
Machinery	20,000,000		
Depreciation (machinery)	-5,000,000		
Intangible Assets			
Patents	1,000,000		
Total Long-term Assets	46,000,000		
Total Assets	62,275,000	Total Liabilities + Net Worth	62,275,000

Internally generated intangibles are not recognised on the BS according to the 2005 IFRS

Investment in HR (training), advertising, brand building etc must be expensed.

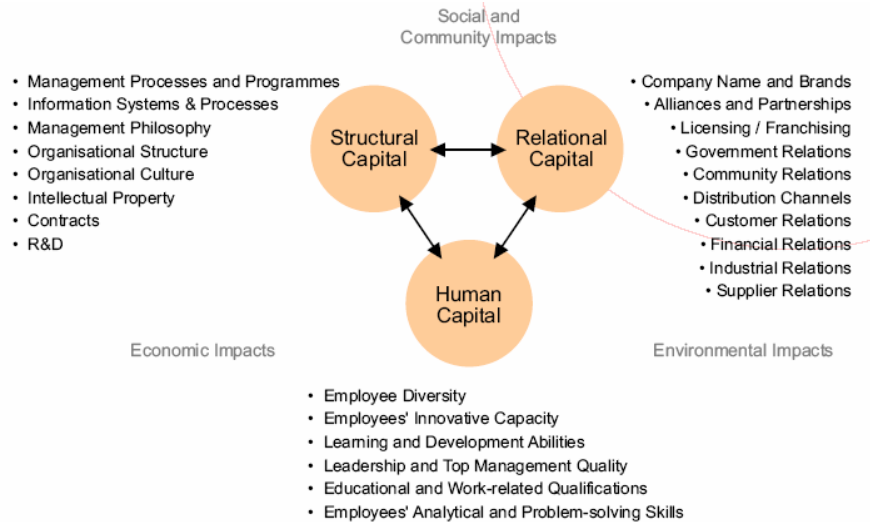


IFRS

- Came into effect on January 1, 2005
- What changed?
 - Internally generated intangibles (i.e. brands, mastheads, publishing titles, customer lists and items similar in substance) could no longer be recognised on the BS. Revaluation can only take place if there is an active market for the intangible (market impairment test).
- Treatment of training, R&D, start-up, advertising and reorganisation costs?
- Question is whether the IFRS provides better information and benefits to companies, investors and the Australian economy?



Invisible Assets Not (always) Shown on the BS



Invisible Assets - Defined

- > **Human Capital** refers to the skills, attitudes, abilities, competencies and qualities of an organisation's employees. It comprises, for example, the knowledge and expertise employees apply to produce products and services, and to the operations of the organisation itself.
- > **Structural Capital** refers to the structures and processes employees develop and deploy in order to be productive, effective and innovative; it includes the virtual, social, cultural and physical infrastructures that influence and guide the work practices, mindsets and collective philosophies of employees.
- > **Relational Capital** refers to the better management of stakeholder relations, be they customers, suppliers, governments, distributors, local communities or others, and is particularly concerned with the creation of reciprocal information flows and learning opportunities between the organisation and its key stakeholders.

Summary: What we see & don't see on the BS

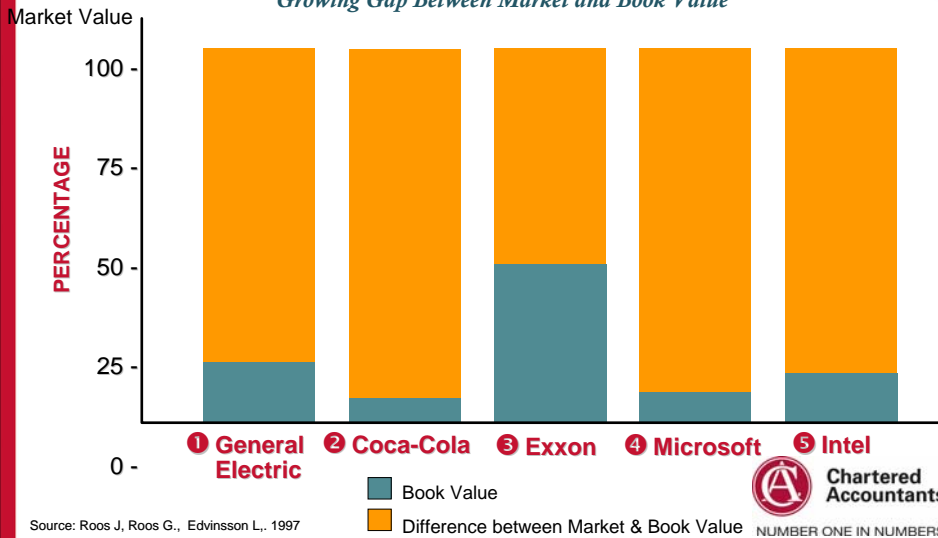
Resource Recognizability	Resource Form			Intellectual Capital Resources		
	Monetary	Physical	Relational	Organizational	Human	
Tangible Resources	<ul style="list-style-type: none"> Cash Investments Receivables/debtors Payables/creditors 	<ul style="list-style-type: none"> Property Plant Equipment Inventory <ul style="list-style-type: none"> Finished goods WIP Parts/raw materials 	<ul style="list-style-type: none"> Customer contracts Formal alliances, JVs, supply agreements 	<ul style="list-style-type: none"> Software Systems Formalized processes Codified knowledge Patents Brands Mastheads 	<ul style="list-style-type: none"> Management contracts ESOP programs LTI programs 	
Intangible Resources	<ul style="list-style-type: none"> Credit ratings Undrawn facilities Borrowing capacity (relative to like companies, based on character) Borrowing covenant slack Receivables certainty Quality of earnings Balance sheet strength 	<ul style="list-style-type: none"> Plant flexibility Plant modernity Infrastructure surrounding plants Stranded assets? Tradability of assets? Access rights Balance sheet strength Inventory (good and usable, obsolete, redundant) 	<ul style="list-style-type: none"> Customer loyalty <ul style="list-style-type: none"> Behavioral Attitudinal Quality of supply contracts Right to tender, right to compete, right to design Strength of stakeholder support (including opinion leaders) Networks Regulatory imposts 	<ul style="list-style-type: none"> Structural appropriateness Informal processes Organizational reputation Brand meaning (strength, stature) Productivity of R&D process Quality of corporate governance Know how, show how Tacit knowledge 	<ul style="list-style-type: none"> Top management quality Top management experience Ability to execute on strategy Bench depth Problem-solving ability Employee loyalty <ul style="list-style-type: none"> Behavioral Attitudinal Personnel reputation 	

Source: AssetEconomics, Inc.
 Note: Contents of each box are not all-inclusive but merely meant to show examples.
 Source: Accenture, 2004

Tracked by traditional accounting systems
 Not tracked by traditional accounting systems

Effect on Company Value:

Growing Gap Between Market and Book Value



Source: Roos J, Roos G., Edvinsson L., 1997
 - see also Sveiby, 1997 p. 6

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Growing Gap Between Market and Book Value

- > Today, Google's market capitalization is approximately **US\$125 billion** while its net tangible assets are worth **US\$9 billion**.
- > Amazon.com has a market capitalization of **US\$13.6 billion** and a net tangible asset value of **US\$76 million**.
- > Microsoft has a market capitalization of **US\$271 billion** and its net tangible assets are worth **US\$36 billion**

Market to book ratio for the S&P 500 is 6.

For every dollar on the balance sheet, \$6 is not (Lev, 2001) – missing, uncounted assets.



Accounting Limitations

What are some of the implications for organisations of the lack of reporting of intangibles?

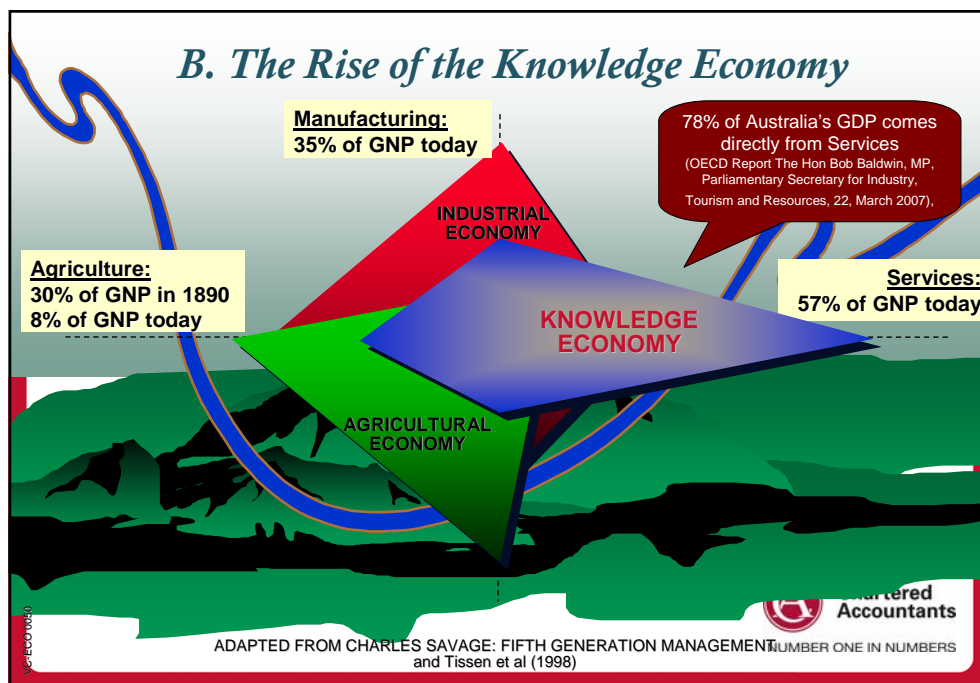
- *Understated earnings, as investments are expensed not amortised.*
- *Understated book value of equity*
- *Increase in the cost of capital – WACC (beta)*
- *Lower share price due to increase in WACC*
- *Information inequality*
- *Underinvestment in the drivers of value creation - ineffective resource allocation*

See also the Department of Industry, Science and Resources, (2001:25+28) report on Measuring A Knowledge Based Economy; see also Mouritsen et al (2004)



Criticism of Accounting Measures

- **Incomplete** (resulting in gap between market and book value)
- **Untimely** and **backward looking**
- Don't always connect to broader **strategic initiatives** and leaves out the intangible drivers of organisational productivity and prosperity



73% of AU Workforce is Employed in Services

	1994-95(a)	1999-2000(a)	Increase
	'000 persons	'000 persons	
Goods producing industries -			
- Agriculture	403.3	437.5	8.5
- Mining	86.1	78.2	-9.2
- Manufacturing	1,115.3	1,113.1	-0.2
- Electricity, gas and water	86.8	64.5	-25.6
- Construction	589.8	695.4	17.9
- Total	2,281.3	2,388.7	4.7
Service industries -			
- Wholesale trade	493.6	494.9	0.3
- Retail trade	1,187.0	1,324.6	11.6
- Accommodation, cafes and restaurants	377.2	432.8	14.7
- Transport and storage	381.4	407.3	6.8
- Communication services	148.4	169.3	14.1
- Finance and insurance	312.9	327.5	4.7
- Property and business services	749.8	988.7	31.9
- Government administration and defence	357.3	345.8	-3.2
- Education	555.6	609.3	9.7
- Health and community services	720.2	828.1	15.0
- Cultural and recreational services	189.2	217.1	14.7
- Personal and other services	303.7	352.3	16.0
- Total	5,776.2	6,497.8	12.5
Total all industries	8,057.4	8,886.5	10.3
Service industries as a percentage of all industries	71.7	73.1	

(a) Annual average.

Source: www.abs.gov.au

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Intangibles Increasingly Drive Wealth Creation

Table 1 - Economic Transformations

	Economic Activity	Factors of Economic Production
Agricultural Economy Pre-1800	Harvesting	Land Land owners and workers
Industrial Economy 18th to 20th century	Manufacturing	Labour Machinery Raw material
Knowledge Economy 20th century and onwards	Mediation of knowledge and services	Relational capital Structural capital Human capital

Boedker et al (2007, p. 5) – Society for Knowledge Economics

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C. New Business Models

Table 3 - Changing Business Models and Organisational Capabilities

Business Model	Organisational Capability and Output
Value Chain Tangible and monetary resources form basis of competitive advantage	Production Objective is to produce products and in doing so reduce costs and increase margins.
Value Shop Human capital forms basis of competitive advantage.	Problem Solving Objective is to produce solutions to problems which entail capturing knowledge about problems and applying problem-solving skills and creativity.
Value Network Relational and structural capital form basis of competitive advantage.	Mediation Objective is to create value through the establishment of connections and the mediation of exchanges. Focus is on managing and developing relationships with actors ² in value network and finding new actors.

Source: Boedker et al (2007, p. 6) – Society for Knowledge Economics



D. Intangibles as a Source of Competitive Advantage to Organisations

- *McKinsey, BAH, BCG*
- *PwC, E&Y, KPMG*
- *ICAA*
- *Southwest Airlines, Ryan Air*
- *BMW, Audi, Mercedes*
- *Harvard Business School*
- *Microsoft*
- *Dell*
- *STA Travel*
- *etc*

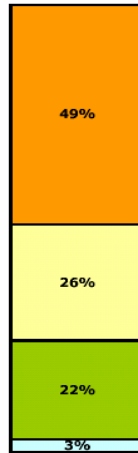
Intangibles are also important to the traditional brick and mortar industries. According to the OECD Science, Technology and Industry Scoreboard 2005 - *Towards a Knowledge-based Economy*, 40% of people employed in manufacturing engage in knowledge intensive service activities.



Intangibles as a Source of Competitive Advantage

How important are intangible assets to your company's long-term shareholder wealth creation?

- Intangible assets are what the company primarily relies on for shareholder wealth creation.
- Intangible and tangible assets are of roughly equal importance to the company for shareholder wealth creation.
- The company has many intangible assets, but relies primarily on tangible assets for shareholder wealth creation.
- The company does not have many intangible assets, and relies primarily on tangible assets for shareholder wealth creation.



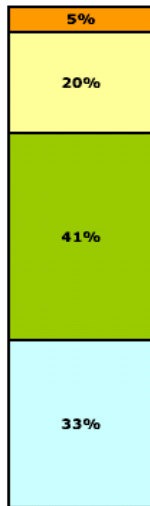
Source: Accenture, 2004



Yet – Measuring and reporting intangibles are a challenge.



Does your company measure the performance of its intangible assets and/or intellectual capital?



- Yes, we have a robust system that measures and tracks all aspects of the performance of our intangible assets / intellectual capital.
- Yes, we apply some measures to assess the performance of our intangible assets / intellectual capital, but they don't constitute an organised system.
- Yes, we apply some measures to assess the performance of our intangible assets, but those measures are mainly informal or qualitative.
- No, we do not measure the performance of our intangible assets/intellectual capital.

Despite of the growing importance of intangibles to wealth creation, not many organisations are good at measuring the value and performance of intangible resources.

Source: Accenture, 2004



Why Might Measurement be a Challenge?

1. Intangible resources can be difficult to identify – the **hidden assets**, which are often 'invisible' and **possibly taken for granted**.
2. Measurement is often **time consuming** and **resource intensive** and can be expensive.
3. How to establish **cause-effect relations**?
4. How to identify **the key performance measures** in the sea of possible measures?
5. Measurement increases **transparency** and **accountability**.



Drivers of Change - Summary

A. Accounting Limitations

B. The Rise of the Knowledge Economy

C. New Business Models

D. Intangibles as a Source of Competitive Advantage



5 Minutes for Questions



2. International Trends & Developments

- what are some of the responses and possible solutions to measuring and reporting on intangibles?



Trends in Reporting and Measurement

	Phase 1	Phase 2	Phase 3	Phase 4	Phase 5
Period	1800-	1960s-	1970s-	1980s-	Late - 1990s
Focus	Accrual Accounting	Human Resource Accounting	Triple Bottom Line, Social & Environmental Accounting	Corporate Citizenship and Sustainability	Human, Structural and Relational Capital
Governors	Accountants and Shareholders	HR Managers, Accountants, Shareholders	Communities and Nations	Stakeholders and 'Global Villagers'	Knowledge Workers and 'Intellectual Capitalist'

Growing focus not just on \$-values recorded in financial statements for the benefits of shareholders, but also more broadly on the public good and value created for a wider range of stakeholders.



Summary of International Trends and Developments in Measurement & Reporting

Source: Boedker et al (2007, p. 13)
Society for Knowledge Economics

	Initiative	Requirement	Category
Global Level	IASB Management Commentary	In Discussion	Extended Performance Management, Measurement and Reporting
	OECD Multinational Enterprise	V	Corporate Citizenship & Sustainability
	United Nations Global Compact	V	Corporate Citizenship & Sustainability
	United Nations Global Reporting Initiative	V	Corporate Citizenship & Sustainability
National Level	Australian Parliamentary Inquiry into Corporate Responsibility and Triple Bottom Line Reporting	V	Triple Bottom Line and Corporate Citizenship & Sustainability
	Australian Guiding Principles on Extended Performance Management (SKE)	In draft format	Extended Performance Management, Measurement and Reporting
	Austrian Universities Organisations and Studies Act	M	Intellectual Capital
	Danish Guideline on Intellectual Capital Reporting (MSIT)	V	Intellectual Capital
	German Guideline on Intellectual Capital Statements (FMEL)	V	Intellectual Capital
	Japanese Intellectual Based Management (METI)	V	Intellectual Capital
	MERITUM Guideline (EU Commission)	V	Intellectual Capital
	UK Operating and Financial Review (ASB)	V	Extended Performance Management, Measurement and Reporting
	US Enhanced Business Reporting Consortium	V	Extended Performance Management, Measurement and Reporting
	Organisational Level	Balanced Scorecard (Kaplan and Norton)	V
Intangible Asset Monitor (Sveiby)		V	Intellectual Capital
ValueReporting™ (PwC)		V	Extended Performance Management, Measurement and Reporting



Some Key Initiatives

1. *Danish Ministry's Guideline to Intellectual Capital reporting.*
2. *Legislative requirements for Intellectual Capital Reporting in Austria*
3. *Global Reporting Initiative by the United Nations*
4. *Reporting requirements in the UK – the Operating and Financial Review*
5. *International Accounting Standards Board – Management Commentary*
6. *Society for Knowledge Economics' Draft Guiding Principles*



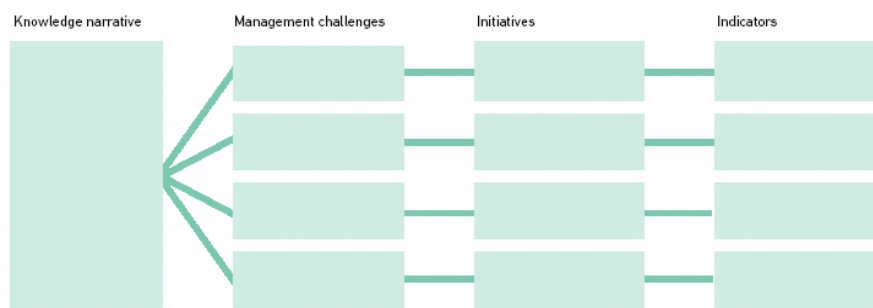
1. Danish Intellectual Capital Statement Guidelines

- IC pilot project run by the Danish Ministry of Trade, Science and Innovation;
- + 150 organisations (private and public sector) participated;
- Produced IC reports over a 5 year period;
- Guidelines for how to prepare an IC report:
 - What are the components of the IC statement model – what do they mean?
 - What is a knowledge narrative?
 - What type of IC indicators to include?
 - How should the project be organised?



The Intellectual Capital Statement Model

Figure 3: The intellectual capital statement model



Source: Mouritsen et al (2003) – Danish Ministry of Innovation, Science and Technology



Example of IC Statement

Knowledge narrative	Management challenges	Initiatives	Indicators
<ul style="list-style-type: none"> Product or service: Secure and systematic assessment of taxes for businesses. Use value: Prevention of unfair competition. Knowledge resources: A simple, effective and correct tax collection system advising users on the administration of often complex statutory rules and regulations. 	<ul style="list-style-type: none"> Deep insight into users' conditions 	<ul style="list-style-type: none"> Analyse users' expectations and satisfaction Monitor business activities Monitor new legislation 	<ul style="list-style-type: none"> Number of new laws on taxes, excises and duties User satisfaction measurement Number of annual surveys
	<ul style="list-style-type: none"> Hiring and retaining employees 	<ul style="list-style-type: none"> Plan future need for competencies Create a family-friendly workplace Promote Odense Customs and Tax Region, including its role in society Develop a relationship between wages and results Develop assignments characterised by responsibility and independence 	<ul style="list-style-type: none"> Staff turnover Age distribution Number of schemes on part-time work, leave and other time off Number of applicants Number of employees with new salaries Number of employees with bonuses Employee satisfaction survey
	<ul style="list-style-type: none"> Development of professional and personal competencies among the personnel 	<ul style="list-style-type: none"> Create an overall understanding of Odense Customs and Tax Region's products Develop knowledge sharing across professions Introduce competency development Introduce development methods 	<ul style="list-style-type: none"> Number of job changes in the organisation Number of courses and other knowledge sharing activities Number of international exchanges Training cost size Competency evaluation
	<ul style="list-style-type: none"> Development of new effective processes 	<ul style="list-style-type: none"> Develop a process and a culture of improvement 	<ul style="list-style-type: none"> Number of process descriptions Number of improvement proposals Benchmarking
	<ul style="list-style-type: none"> Electronic accessible rules, practices, processes and experience 	<ul style="list-style-type: none"> Anchor rules, practices, processes and experience electronically Monitor results of new legislation, user behaviour etc. 	<ul style="list-style-type: none"> Number of applied process descriptions Number of decisions Number of new acts and changed practices

Source: Odense Customs and Tax Region

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2. Austrian Legislation on IC Reporting

On January 1, 2004, the University Organisation and Studies Act (Universities Act 2002) came into effect for all state universities in Austria.

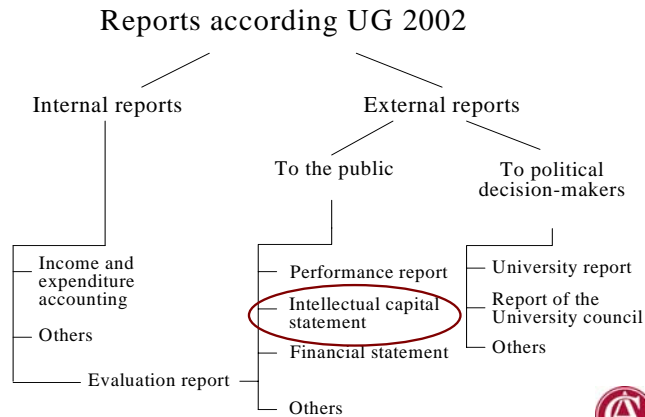
Purpose:

The IC statement is designed as an **inventory of the existing intellectual capital** within the university; Knowledge, or similar: intellectual capital, is the most relevant production factor for universities and hence should be made visible. The IC statement is structured into **human, structural and relationship capital**.

.... the new reporting system **enforces transparency** inside and outside universities: Externally, the IC statement shall represent a possibility to **publicly account for the use of tax money** and to publish the university's performance; Internally, it shall deliver information for management and control.

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2. Austrian Legislation on IC Reporting



(Schaffhauser-Linzatti, 2004)



2. Austrian Legislation on IC Reporting

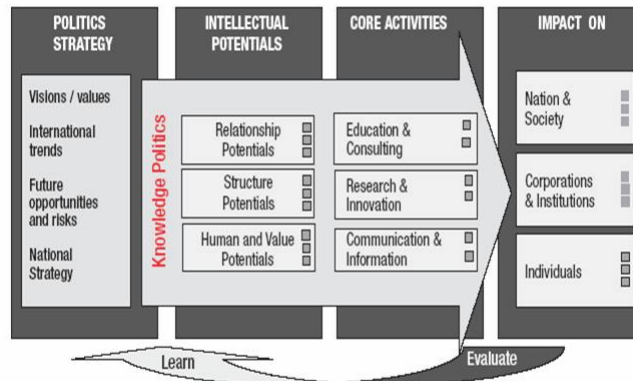
Purpose (cont'd):

- The statement serves as an important basis for the university's **budgetary reimbursement**; the IC information will inform performance-oriented budget allocation from the Federal Ministry and from private institutions.
-this is envisioned to contribute to :
 - reallocation and a more **effective and efficient use of resources**,
 - improvement in **management decision making and forecasting**,
-(also envisioned to) enforce competition on public and also private resources and result in an increase in the performance of Austrian universities.



A National Report on Intellectual Capital....

A national IC Report (as the one under development for Austria) focuses on overall objectives and strategic key success factors of Integrated Knowledge Politics for a country.



National IC-Model (wbö) following the original "Wissensbilanz" model of U. Schneider & G. Koch, 1998 / 1999

Figure 3. Austrian Structural Model for a national Knowledge Report

3. Global Reporting Initiative

The GRIs are part of the United Nations Environment Programme (UNEP); works in cooperation with UN Secretary-General Kofi Annan's Global Compact. It is a multi-stakeholder process and independent institution. The objective is to develop and disseminate globally applicable Sustainability Reporting Guidelines; for voluntary use by organisations for reporting on the economic, environmental, and social dimensions of their activities, products and services. The group incorporates representatives from business, accountancy, investment, environmental, human rights, research and labour organisations from around the world.

3G guidelines released in 2006.

Consultation for 3Gs had 31 countries represented and showed:

1. Respondents generally welcomed the direction that the G3 was heading, and noted it was an improvement on the 2002 Guidelines, particularly around enhanced user-friendliness and comparability.
2. The reporting principles were highly popular amongst respondents.
3. The 'relevance and materiality' principle attracted detailed attention. Many respondents called for increased clarity and a shift to using one word rather than both.
4. Boundary guidance was generally seen as a useful addition.
5. Many respondents welcomed the addition of the Disclosure on Management Approach. Amidst this positive feedback remain questions of how to balance the need for comparable and narrative information.
6. Indicators underwent changes from G2 to G3 to become more performance-focused.

<http://www.globalreporting.org/about/brief.asp>

4. UK Operating Financial Review

- The UK Department of Trade and Industry issued a **mandatory** statutory requirement in April 2005. whereby public listed companies had to prepare and report an Operating and Financial Review (OFR). The OFR was later changed to **non-mandatory**.
- The OFR was designed to help **shareholders get a more complete picture of a company's business**; - enabling them to assess a “company's strategies and the potential of them to succeed”.
- Patricia Hewitt, Trade and Industry Secretary, describes it as going some way to “**strengthen corporate Britain**” – the idea being that investors equipped with higher-quality information could **make better-informed decisions**;
- The UK **Accounting Standards Board** is responsible for the statutory requirements of the OFR.



4. UK Operating Financial Review

Content:

The OFR requires organisations to provide a **balanced and comprehensive analysis** of:

- the nature, **objectives and strategies** of the business;
- the **development and performance of the business**, both in the period under review and in the future;
- the **resources, risks and uncertainties** and **relationships** that may affect the entity's long-term value; and
- the position of the business including a description of the capital structure, treasury policies and objectives and liquidity of the entity, both in the period under review and the future.

This must include **negative** as well as **positive information**.

In so far as necessary, the OFR must also include **information on persons with whom the entity has relations**, such as:

- employees;
- environmental matters;
- social and community issues; and
- receipts from, and returns to, shareholders customers and suppliers;



5. International Accounting Standards Board

- > The IASB issued a [Discussion Paper](#) on MC in 2005 and a call for commentary
 - It was agreed that the IASB should issue a [principles-based standard on MC](#), together with [non-mandatory implementation guidance](#).
 - The objective of MC is to assist current and potential investors in assessing the strategies adopted by the entity and the potential for successfully achieving them.
 - The IASB also issues a call for Comment Letters on the Discussion paper

- > The IASB undertook an [Analysis of Comment Letters](#) on the Discussion Paper discussed in Jan 2007 at the IASB meeting. This resulted in the following
 - 61% of the respondents said that that MC should not be mandatory and that entities should not be required to include Management Commentary (MC) in their financial reports to
 - By a majority of 12 votes the Board decided to go forward with this project and directed the staff to [prepare an Agenda Proposal](#).

See: <http://www.iasplus.com/agenda/mda.htm>



6. Society for Knowledge Economic

- > **Our aim:**
 - To ensure Australia's success as the leading Knowledge Economy

- > Formed in 2005 by the AGCCKC
(*Australian Government Consultative Committee on Knowledge Capital*)

- > **Partners include:**
 - Westpac, Microsoft, CSC, Actuaries Australia, CPA Australia, E&Y, PwC, Deloitte, NSW Lands, Dept of Finance, Universities and other experts



What is a Knowledge Economy?

A Knowledge Economy is an economy in which knowledge and knowledge intensive resources are consciously developed, configured, explored and utilised in the pursuit of social and economic prosperity and productivity.

In the words of Dahl from the World Bank (2003)^[1], a Knowledge Economy is

“an economy that creates, acquires, adapts and uses knowledge effectively for its economic and social development”.



6. Society for Knowledge Economic

Our Work:

- *Collaborative* projects and research into the drivers and practices that support healthy economic and social prosperity
- *To produce insights, ideas, tools and policy recommendations*
- App. 10 research projects at various stages



6. Society for Knowledge Economic

Projects include, among others:

- *Guiding Principles* – now adopted by [ARA for Knowledge Capital Reporting Award](#)
- Innovation Report with Business Council of Australia
- Global Trends in EPM (commissioned by Dept of Finance)
- [NSW Lands Intellectual Capital Reporting](#)
- Westpac Innovation Project and Project on Measurement of Intangibles
- [Sustainability Valuation project with Ernst and Young](#)
- Human Capital – Australia's Capability

6. Society for Knowledge Economic

- > To find out more
 - www.ske.org.au
- > Or send us your contact details to stay in touch with upcoming programs
 - info@ske.org.au

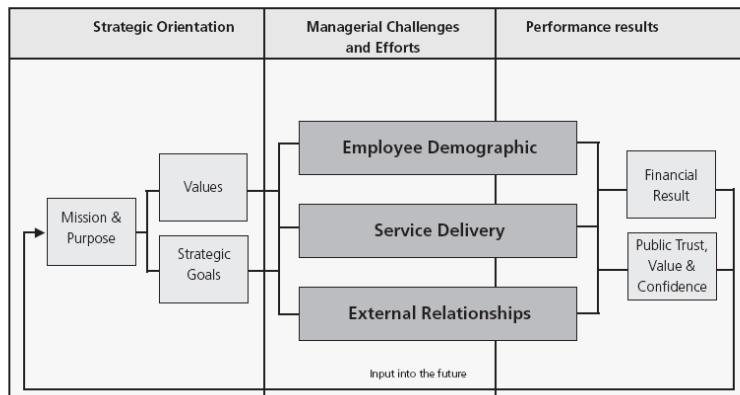
Possible Solutions

Organisational Frameworks for Managing, Measuring and Reporting Intangible Resources



NSW Department of Lands

Figure 1 - Lands Intellectual Capital Framework



Source: NSW Department of Lands IC report 2004/05 and 2005/06

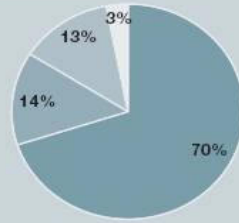


Examples from IC Statements

"Freedom with responsibility"

Masters and PhD
Other software education
Diploma engineers/Bachelors
Domain specialists

Level of Education for Systems Engineers
(as of 30 Sept 2003)

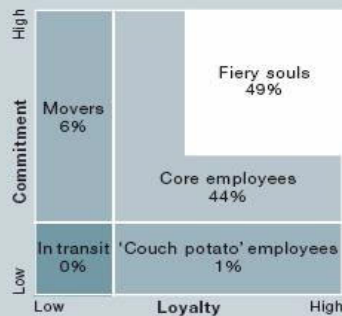


Source: Systematic's IC statement



Examples from IC Statements

Employee Commitment and Loyalty (2003)

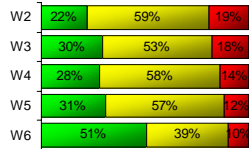


Source: Systematic's IC statement

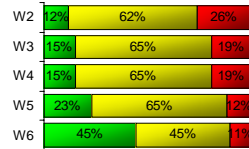


"CPE Thermometer"

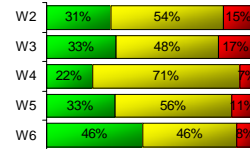
My leadership team demonstrates through their own actions that satisfying external customers is top priority (Q9)



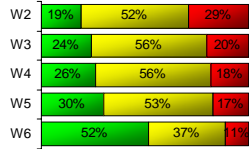
My department coordinates effectively with other departments to serve external customers better (Q11)



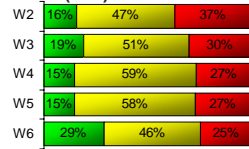
My department systematically uses external customer feedback to take actions that improve customer satisfaction (Q15)



I feel empowered to do what it takes to satisfy our external customers (Q21)



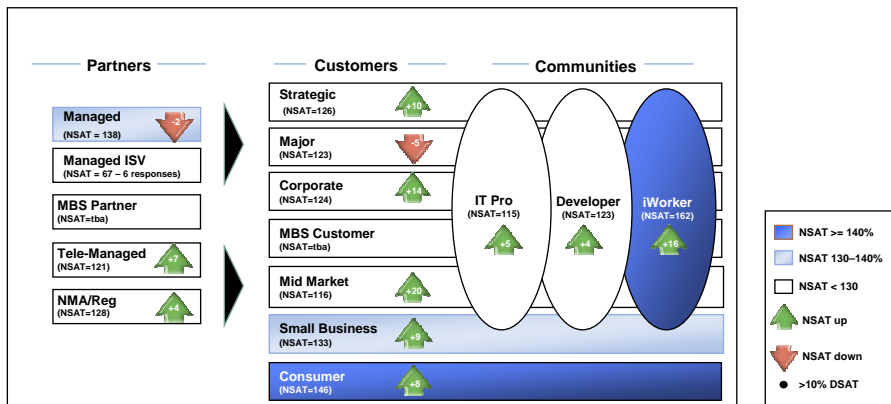
Internal metrics and processes are in place to measure how successful I am in satisfying our external customers in the local market (Q23)



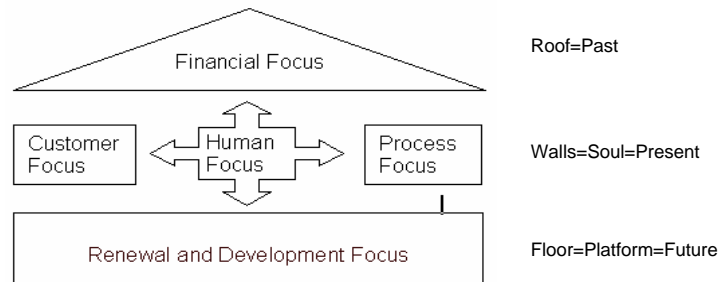
Relatively high number of skeptics



FY06 WWCPS Results and Trend for Australia



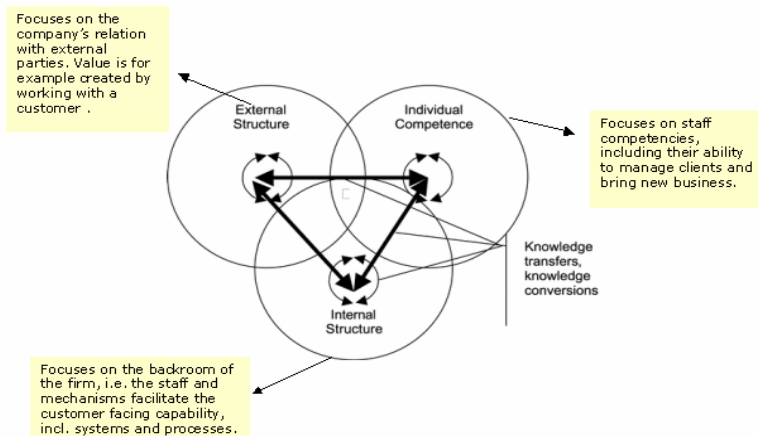
The Scandia Navigator: The House Metaphor



Source: Skandia's Annual Report 1994, p. 7



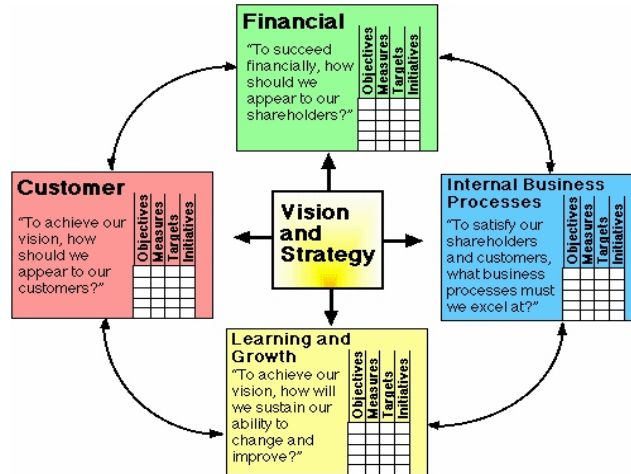
Sveiby's Intangible Asset Monitor



Source: Sveiby, 2000



The Balanced Scorecard



Source: Kaplan and Norton (1992)

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3. Effects of Measurement and Reporting

– what are some of the benefits and challenges to organisations and other stakeholders incl. capital markets

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Accounting Limitations

What are some of the implications for organisations of the lack of reporting of intangibles?

- *Understated earnings, as costs are expensed not amortised.*
- *Understated book value of equity*
- *Increase in the cost of capital – WACC (beta)*
- *Lower share price due to increase in WACC*
- *Information inequality*
- *Underinvestment in the drivers of value creation - ineffective resource allocation*

See also the Department of Industry, Science and Resources, (2001:25+28) report on Measuring A Knowledge Based Economy; see also Mouritsen et al (2004)



Use and Benefits of Measuring and Reporting

1. An Internal Performance Management Tool, which

- ✓ *Makes visible the organisation's invisible, often overlooked, resources (i.e. S&S); thereby providing a more **balanced view** on performance;*
- ✓ *Places intangible resources within a **strategic context**;*
- ✓ *Improves the quality of decision making and **resource allocation**;*
- ✓ *Enhances organisational **sustainability** and reduces organisational **risk exposure** by making visible the invisible;*
- ✓ *Provides employees with a common referent for understanding, managing and developing the organisation.*



Use and Benefits of Measuring and Reporting

2. A External Reporting Tool, which:

- ✓ *Provides **external stakeholders** with a broader perspective on organisations' value creating activities and abilities to base their investment decisions on;*
- ✓ *Helps reduce the cost of capital and improve **company valuations** by increasing transparency and awareness.*
- ✓ *Supports and enhances organisations' **image and reputation** among key stakeholders including employees, customers, financial market players etc.*



Impact on Company Performance

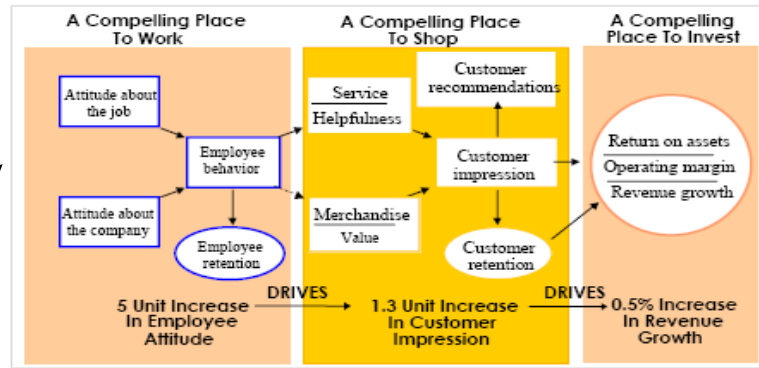
Sears Case Study:

“A 5 point improvement in **employee attitude** will drive a 1.3 point improvement in **customer satisfaction** which in turn will drive a .05% improvement in **revenue growth**”.

(Rucci, Kearn and Quinn, 1998, p. 91)



The Sears Model*



* "The Employee-Customer-Profit Chain At Sears." *Harvard Business Review*, January-February, 1998.

Employee Attitude is identified as the most important (leading) indicator at Sears

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Impact of Reporting on Share Price

PwC conducted an experiment on the effects of intellectual capital reporting with Investment managers at a UK Investment Management Firm. They gave one group of Investment Managers the financial reports only. The other group received both Coloplast's intellectual capital report and its financial reports.

The Results were as follows:

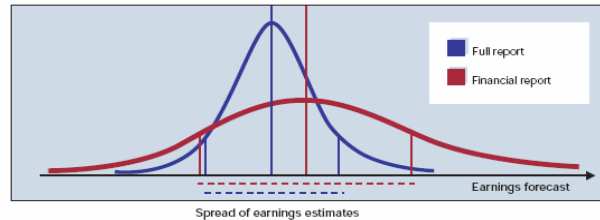
Spread of earnings estimates: The group with the full set of information generated a much tighter range of earnings estimates than those using just financial performance. Uncertainty was reduced. "Those with the full information set were **more confident in their forecasts with the result that they awarded a higher valuation to the stock** – hence the propensity towards 'buy' recommendations" (p. 80).

Beta: The group with just the financial data, awarded an 'above average sector risk'. By contrast, those who had a more comprehensive picture of overall corporate performance held the stock to be no more risky than its peers.

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Impact of Reporting on Share Price (cont'd)

Figure 1: Spread of earnings estimates generated by investors



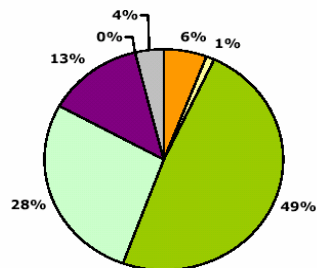
“Similarly, when presented with just financial information, uncertainty in the economic projections for the company increased and the value of the firm was questioned. We can assume therefore that, although investors’ analytical models may be financially driven, **the factors that allow an analyst to gain confidence in them – such as revenue growth, margin trends – are typically non-financial in nature.**”

.....Companies failing to make this visible in a credible and well-structured way cannot be surprised if investors assume the worst when placing a value on their estimates of future financial performance” (p.81).



Why Report? (Accenture Study)

Does company disclosure on the performance of intangible assets make a difference in the valuations that analysts make?



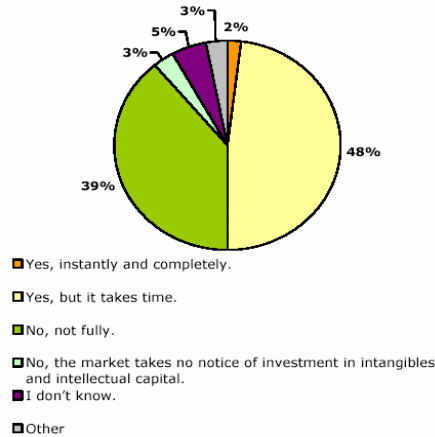
- Disclosure has a dramatic positive impact on analysts’ valuations.
- Disclosure has a dramatic negative impact on analysts’ valuations.
- Disclosure has an appropriate impact (relative to the value contribution of intangible assets) on analysts’ valuations.
- Disclosure has a modest impact on analysts’ valuations.
- Disclosure has only a marginal and occasional impact on analysts’ valuations.
- Disclosure has absolutely no impact on analysts’ valuations.
- Other

Source: Accenture, 2003



Why Report? (Accenture Study)

Does the stock market reward companies that invest in intangible assets and/or intellectual capital (assuming adequate disclosure of these investments)?



Source: Accenture, 2003



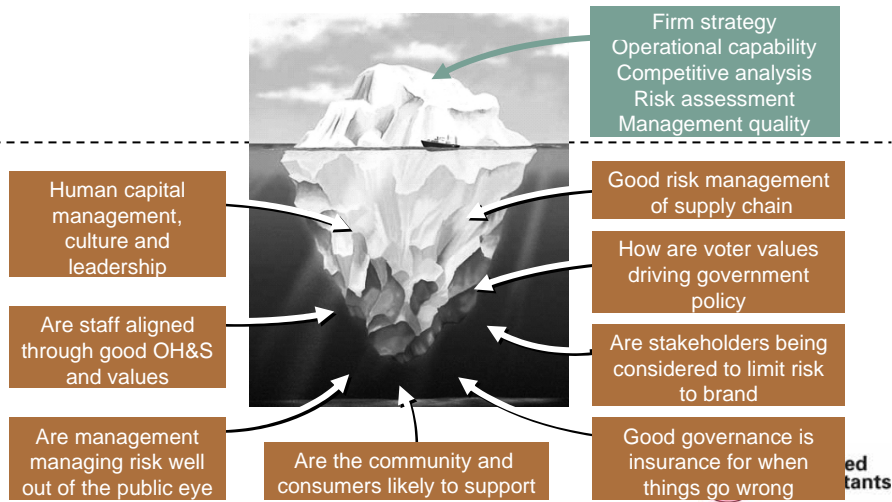
Annual Reports?

- > PwC (1998, p. 9) surveyed 50 institutional investors and 30 sell-side analysts and asked participants about the perceived usefulness of financial reports. The study found that "over 80% felt the financial report is at best fairly useful".
- > Similarly, Holland (2003, p. 43) found that information not reported in annual reports contributes between 25 and 50 percent of the relevant information used by Fund Managers in company valuations.



AMP Presentation (2 Feb 2007):

Adding value through researching more dimensions



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AMP Presentation (2 Feb 2007):

New era in company evaluation

Adding value through analysing more dimensions

Price = Cash flow grown over time and discounted

= Cash flow

[risk free rate + risk premium] - growth

Management quality

Committed workforce

Loyal customers

Rightsourcing

Climate change

Meeting Gen Y needs

Informational
democracy

Effective analysis improves line of sight on risk and growth

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Relevance of Intellectual Capital Indicators

Which company would you invest in? X or Y?

	Software Engineering X			Software Engineering Y		
	2001	2002	2003	2001	2002	2003
Workforce profile (age)	55% +55 years old	57% +55	58% +55	55% +55	52% +55	50% +55
Five largest project customers (% of revenue)	48%	70%	81%	48%	50%	49%
New Strategic Customers	2	0	1	2	3	4



Relevance of Intellectual Capital Indicators

Table 5 - Changing Information Requirements of Company Directors

Facts at a Glance

In order of importance, the 1016 company directors surveyed in the McKinsey survey wanted to know more about:

1. **Market Health**
Customer profitability/satisfaction, competitors' market share and products, suppliers, brands.
2. **Organisational Health**
Employee retention/satisfaction, capabilities and skills, organisational structure, culture, values.
3. **Network Health**
Regulatory changes, government policies, public opinion, community views.
4. **Financial Performance**
Cash, costs, EBITDA, margins, return on capital.
5. **Operational Health**
Buildings, inventories, patents, product pipeline, production rates.

Source: McKinsey, 2005

Boedker et al (2007, p. 9) – Society for Knowledge Economics



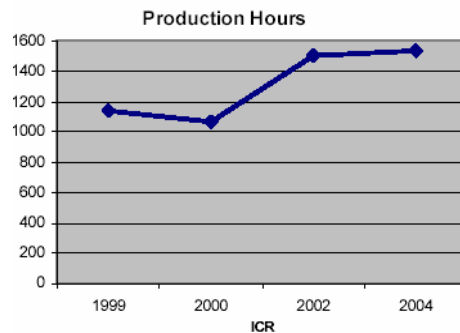
Challenges Associated with Measuring and Reporting

1. attracting resources;
2. developing and sustaining **interest and commitment** from executives, employees and others;
3. attracting (**visionary**) teams leaders (do we have the skills and knowledge?);
4. determining levels of **responsibility and accountability**;
5. overcoming employee **resistance** and challenging the status quo;
6. identifying and tracking the value and performance of knowledge intensive resources including **cause-effect relations**; and
7. freeing up time – it is a **time consuming** and resource intensive process (see o'leaf).



Resource Requirements

Production hours averaged 1050 in 2000 and 1550 hours in 2004.



Source: Mortensen M. (2004), "Systematic Software Engineering – Experiences with IC Reports", presented at the Intellectual Capital Conference in Helsinki, Sep. 2-3, 2004



4. How Might the Future Look?

Trends

- > Increase in discourse and activities related to intangibles / intellectual capital (DK, Austria, Finland, Japan, GRIs etc)
- > But.... still in early stages of 'lifecycle' with many frameworks and diversity in terminologies and reporting practices
- > Establishing cause-effects between intangibles and financial performance remains a challenge
- > As do information objectivity and assurance - beauty competition argument

Sustainability and Knowledge Capital Reporting

- > Is (not?)
 - PR
 - A Beauty contest



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International Accounting Standards Board

- > **Challenges identified during the Jan 2007 IASB meeting:**
 - Some respondents raised the concern that MC **lacks the same degree of objectivity** as financial statement information.
 - Others noted that important consequences for the audit will arise since the **audit of MC** poses significant challenges compared to an audit of financial statements.
 - Other issues like **objectivity**, essential contents and the form of guidance were briefly discussed but no majority views became apparent.

<http://www.iasplus.com/agenda/mda.htm>

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Austrian Legislation on IC Reporting

Challenges:

- Missing **uniformity of use**: internal vs external application and relevance;
- Missing uniformity of **terminology and definitions**; diversity reduces the general understandability and interpretability of IC statements;
- Missing **uniformity in approaches / frameworks** for measurement and reporting



ICAEW (2001) Study

Challenges to Reporting on Intangibles

- Limited and **inconsistent** reporting across years and companies
- **Validity** and **objectivity** (question of assurance)
- **Transparency** and **competitive** intelligence issues

Study based on

Content analysis of annual reports of 125 FTSE companies
Interviews with 47 Chairpersons / Senior Executives
Survey sent to 1568 financial analysts, response from 290 (18.5%)
Interviews with financial analysts

Other issues

Capacity for interpretation (Holland, 2003)



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**Please hand in your evaluation forms
at the door as you exit**

Thank you

