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The benefits of IC Reporting

And obstacles in the way

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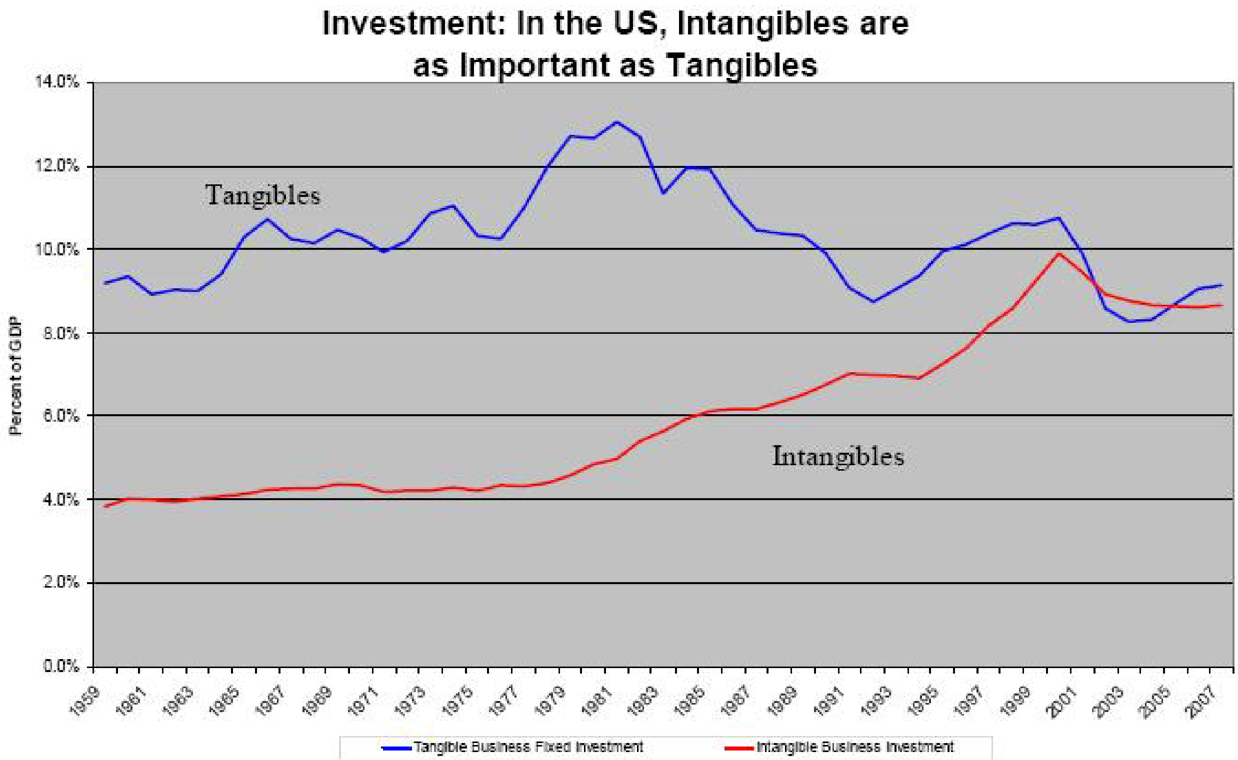
Introduction

We live in the information era, a period during which knowledge organizations are leading the economy from the front. This is reflected in the massive growth of the services sector on the one hand. Industries such as IT (Information Technology) and BPO (Business Process Outsourcing), which were non-existent during the industrial era, are now the biggest job creators in this era. On the other hand, even the manufacturing sector - dominated by labor and capital equipment for decades - is seeing a steady shift in focus from production activities (which are being continuously outsourced) to design and marketing, both knowledge intensive activities. In like vein, even the agriculture sector is focused more on increasing productivity and the means thereof (green pesticides, genetically modified seeds, biotech, etc which are all knowledge intensive activities) rather than on sowing and harvesting, activities which have already been mechanized in the previous era. Companies in this era have therefore consciously come to realize the importance of making investments in their intangible assets, which are the holders of their knowledge capital and the source of their competitive advantage. This can be seen from the graph below, which shows the increasing amount of investments being made in intangibles by companies in the US, the largest economy in the world, over the last 50 years. Up until the 1980s, investment in tangibles used to be about 10% of GDP and that in intangibles was about 4% of GDP. Since the 1980s, which coincides with the proliferation of computers and the start of the knowledge era, investment in intangibles has constantly increased and that in tangibles has slightly decreased to the point where both now stand at about 9% of GDP.

These intangible assets, comprising among other things the human skills and knowledge of employees, internal databases and processes and Customer relationships have come to be known broadly as the Intellectual Capital of the Company.



Source: working paper no. 08-23 intangible assets and national income accounting Leonard I. Nakamura Federal Reserve Bank of Philadelphia, October 2008

Let us take a closer look at the exact benefits that Intellectual Capital has to offer as well as some of the issues that come in the way of realizing these benefits.

Benefit to Companies

Companies could use information about their intellectual capital to fine tune their corporate strategy. As we know, Corporate Strategy is the set of planned actions that will result in giving a decisive competitive edge to the Company. Three general purpose strategies are seen very commonly – low cost, niche product or service and regional presence. Each one of them requires the company to cultivate specific core competencies in order to leverage that specific strategic theme. Low cost produces need core competencies in the most optimal cost of production techniques. Niche providers of a product or service need to have overwhelming depth of knowledge in their area of specialization and be able to seamlessly scale up capacity with increasing demand. Finally, regional providers need to be able to localize their services to such an extent that it creates extensive Customer comfort and significant barriers of entry to competitors. In all three cases, relevant core competencies need to be nurtured and cultivated for sustaining the competitive advantage. Core competencies themselves are nothing more than combinations of intangible assets that come to play in a unified fashion for realizing the desired effect. For instance, a company that has core competencies in microchip design would probably have a combination of talented chip designers, access to a rich database of information which details the limits and possibilities in silicon technology, a set of marketing professionals who are adept at expressing their Customers needs and very short and effective internal lines of communications.

A Company that has discovered the true sources of its competitive advantage could therefore easily use that knowledge to make everyday improvements and continuously build barriers to entries for others. Moreover, such a company would also be able to optimize their capital expenditure by choosing to spend only in those projects that create value.

Companies could also use information about their Intellectual Capital to convey the right image of themselves to various stakeholders, such as

- Investors and lenders – for availability of capital at the most optimal rates.
- Customers – for providing them more detailed and believable information about little known aspects of the company such as innovation and cost leadership.
- Potential employees – giving them more awareness about attributes that form the culture of the company and for attracting the right employees.
- Potential suitors – for right valuations of their intellectual property assets.

Benefit to Providers of Capital

Companies typically raise money for financing their growth using a combination of debt and equity. In either case, Companies could use detailed information about their Intellectual Capital for mutual benefit when dealing with both Lenders and Investors.

An Intellectual Capital Report could greatly improve the perception of risk by providers of credit such as banks by lending to a Company whose value creation process is not only understood but is actively managed by the Company. Banks could therefore be willing to lend money to such companies on terms which are better than to those companies where the value creation process is not sufficiently clear. This would be beneficial for the bank as well since less risky loans would significantly lower the percentage of Non Performing Assets on the Bank's balance sheets.

Unlike debt which is term oriented, equity investors get a stake in the company's ownership in return for investing in the company. Promoters of such companies therefore prefer their investors to have a long term view of their business and stay invested in it, just as they do. This objective is greatly fulfilled by an Intellectual Capital Report which not only outlines the value creation process but also enables Investors to judge whether that process is sustainable in the long term. Investors could use this information to optimize their investment portfolio and maximize their long term returns. Moreover, if Companies also disclose the dollar value of their Intellectual Capital, Investors could use this information for their benefit by using it to discover under and overvalued stocks, thus improving the quality of their investment decisions.

Benefit to Society at large

Publishing and disseminating details about Intellectual Capital also benefits society at large. For one, it leads to efficient utilization of both debt and equity capital. This in turn leads to availability of greater amounts of capital which in turn can be utilized for creating more businesses and more jobs. Secondly, Intellectual Capital Reports also increases the awareness and confidence of investors in the core capabilities of the Company and enables them to stay invested during moments of crisis. This in turn leads to reduced volatility in the company's stock and in aggregate in the overall capital market. Finally, prospective candidates are able to use the information in the Intellectual Capital Report to target the right kind of companies matching their own profile. This leads to reduced attrition rates and considerably lowers the cost of acquisition and retention of employees for the Company. The savings so achieved directly flow to the bottom line of the Company's Profit and Loss account, benefiting both the Company and its investors.

Obstacles to IC Reporting

Thus we see the potential of Intellectual Capital Reports to feed upon itself for the mutual benefit of the Company and its investors. From the preceding discussion, it is amply clear that managing and publishing information about its Intellectual Capital is of paramount importance to every Company. The question that arises therefore is why does this not happen. What are the obstacles in the way? The answer to this question can be grouped into four broad categories.

Not Allowed

Accounting principles allow only acquired Intellectual Capital to be put on the Balance Sheet. Named goodwill, it represents the excess amount over the market value that one Company pays when acquiring another Company. These same principles require all internal spending on intangibles to be expensed immediately rather than be capitalized as assets and depreciated over time. Hence spending on the development of Intellectual Capital never shows up on the Balance Sheet as assets. Rather they show up as expenses in the Profit and Loss statement and impact the company's bottom line immediately.

Not possible

Accounting systems keep track of finance by recording each and every monetary transaction as soon as it takes place. While this system works beautifully when keeping track of money, it fails when it comes to keeping track of the value of intangibles. This is because the value of intangibles can change without any transaction taking place. For e.g. a Company may conduct internal training to quickly familiarize new employees with the world class production processes followed by it. This will result in an increase in intangibles (number of employees trained in world class production processes) yet there will be no monetary transaction to reflect this change.
Moreover, intangible assets are impossible to count and keep a tally of. Hence present day accounting systems deem it impossible to keep track of intellectual assets.

Not desirable

Companies are averse to divulging any more information about their operations other than what is absolutely required by law, in order to avoid giving away competitive knowledge.

Not required

Present day statutory regulations do not require companies to reveal information about their operations or the value of their business. The intention of the Balance Sheet is not to represent the value of the company but to match costs and revenues. Independent analysts that track companies in the capital markets use their own methods for arriving and reporting at the right valuation of Companies. Hence reporting on Intellectual Capital is a burden that Companies do not feel obligated to take.

Summary

Thus to a large extent, it is the myopic accounting view of reporting prevalent today that prevents Intellectual Capital data from being reported to the general public.

Attainix Consulting therefore believes that a voluntary disclosure of Intellectual Capital data by means of an Intellectual Capital Report along with the regulatory financial reports will be to the company's own benefit as detailed at the start of this article. Moreover such reports will also enable investors to make better investment decisions and will benefit society at large by enabling efficient use of capital.

Attainix Consulting focuses on providing software and consulting services that enable firms to convert their strategies to measurable actions. Attainix Consulting was founded on the premise of enabling organizations to manage their intangible assets. For more information, please contact us at info@attainix.com or visit our web site at www.attainix.com