

What is an IC Report?

And what you need to produce one

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Introduction

An Intellectual Capital Report (IC Report) is a voluntary supplement to a company's financial report that provides detailed information about the intellectual assets of the organization. It helps in improving the organization's internal processes for managing its intangible resources. It also provides a sound basis for dialogue with financiers by explaining why the organization does what it does and how it is building the resources and capabilities necessary to succeed in the future. IC Reports help to clarify the way in which competitive advantage is being built and managed by the Company by providing a narrative which explains both value chain positioning and the business model for value creation.

Why is it needed?

The traditional balance sheet was designed for publishing financial assets and hence is ill equipped for the disclosure of intellectual assets. These assets, such as accumulated knowledge through R&D, human resources, new organizational processes and customer relations have become key drivers for value creation and sustainable growth in the knowledge economy. The expansion of the services sector, emergence of new information technologies and increased competition resulting from globalization and deregulation has only accelerated this evolution. Consequently, market pressure has intensified for the public disclosure of such assets in the interest of enhanced capital efficiency and more effective corporate governance.

Companies therefore need an additional instrument – an IC Report – for disseminating information about their Intellectual assets to both internal and external stakeholders. The goal of a well

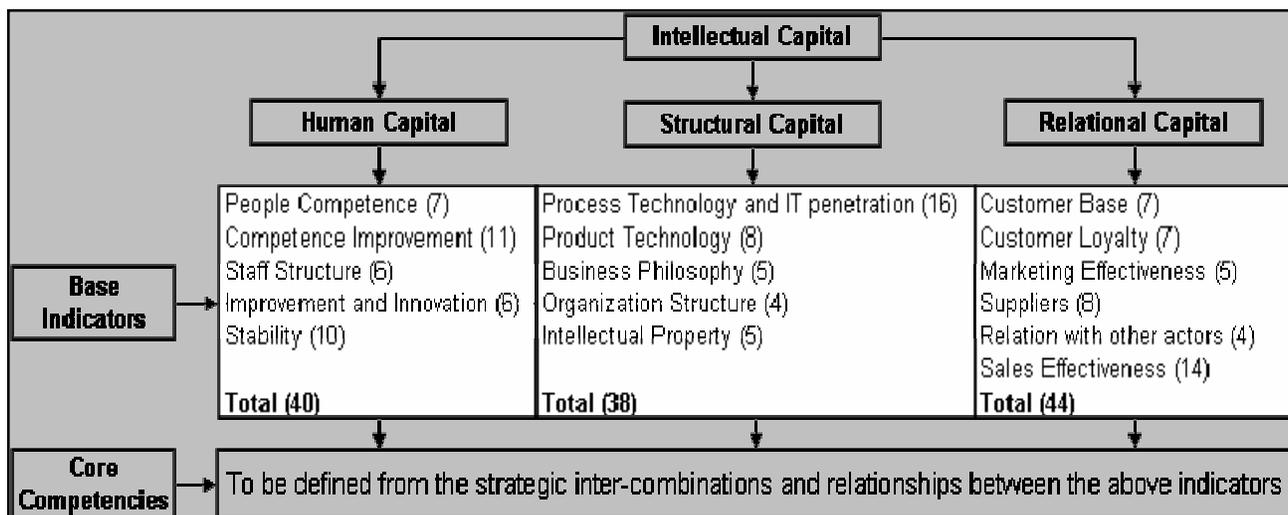
designed IC report should be to highlight the corporate strategy for intellectual asset management and to identify strategic value drivers of the company.

How should it be built?

Unlike financial reports, whose structure and format are regulated by national accounting boards, generic purpose formats for IC reports do not yet exist. Many international organizations such as the OECD (Organization for Economic Cooperation and Development) and EFFAS (European Federation of Financial Analysts Societies) in addition to several Federal Governments (Austria, Denmark, Germany, Sweden, UK, etc.) have published guidelines and best practices on how an IC report should be structured. Inadvertently, these well meaning initiatives have led to divergence and created more confusion in this area. In an effort to simplify this situation, Attainix Consulting has picked out the most common elements of these guidelines and best practices to create a framework and a process of reporting that is of relevance to most organizations as well as a report structure that is of relevance to the capital markets. Attainix Consulting believes that in order to avoid getting confused by the divergent literature that exists in this space, organizations should build their IC Report in three distinct phases:

- Phase 1 – The Basic IC report, containing standard intangible indicators that can be compiled very quickly
- Phase 2 – The Enhanced IC report, which groups the intangible indicators from the basic report into core competencies thus focusing on the areas of value creation
- Phase 3 – The Model IC report, which values the core competencies by putting a monetary value on them

The framework that Attainix Consulting has put together for this purpose is shown below. The numbers in brackets indicate the number of indicators that are pre-defined for that specific cluster.



Framework for Intellectual Capital Reporting – Attainix Consulting

What should it contain?

Phase 1 - The Basic IC Report

Most experts advocate segregating Intellectual Capital into its components – Human, Structural and Relational Capital – and reporting the value of indicators that comprise these components from one reporting period to the next. Attainix Consulting believes that such an approach can produce only basic IC reports; nonetheless it is a quantum improvement over financial reports. Of the myriad formats that exist in this space, Attainix Consulting recommends using the format that has come out of the INTELLECT project. This format is very simple to use and yet it is comprehensive. It sub-divides the three IC components further into 16 clusters and provides over 120 pre-defined indicators that are of relevance to most organizations. Companies can use this format out of the box for preparing a first cut IC Report that will reveal more than what the numbers tell. A sample of a basic IC report using this format is shown below.

	Intangible indicators grouped by Cluster	Target	2007	2006
Human Capital	People Competence			
	Versatility Index	↗	93.7	94.5
	Competence Improvement			
	Percentage of sales invested in training	→	7.1	7.3
	Staff Structure			
	Number of employees with external teaching assignments	↗	38	39
	Improvement and Innovation			
	Number of improvement suggestions made by employees	→	41	38
	Stability			
Employee attrition (%)	↗	18	22	
...	
Structural Capital	Process Technology and IT penetration			
	Number of processes operating through Company Intranet	↗	19	17
	Product Technology			
	Percentage of sales invested in R&D	→	7	7
	Number of products that are industry certified	↗	8	7
	Business Philosophy			
	Technical area Customer Satisfaction	→	4.5	4.4
	Number of research projects in collaboration with partners	↗	3	1
	Organization Structure			
	Number of employees per manager	↗	11	8
Intellectual Property				
Number of papers published during the year towards industry standards	↗	38	26	
...	
Relational Capital	Customer Base			
	Percentage of customers who pay on time	↗	74	72
	Customer Loyalty			
	Average waiting time for user support (in seconds)	↘	15	18
	Marketing Effectiveness			
	Percentage of sales invested in marketing	↗	4	3.5
	Suppliers			
Average number of suppliers per product	↘	18	22	
Relation with other actors				

	Number of days on which company hosted industry events	→	29	26
	Number of industry events in which company participated	→	15	13
	Number of industry forums with representatives from Company	→	7	7
Sales Effectiveness				
	Revenue per salesperson (USD)	↗	5644	5674
			8	8

Phase 2 - The Enhanced IC Report

A basic IC report, although an improvement over financial reports, does not quite illustrate how value is created out of the intangibles that are being reported. Value, as we know, is created whenever a company leverages its core competencies to do something better than its competitors. A core competence results from “collective knowledge” inside the organization and typically results from the interaction of intangible assets, often from different clusters. For instance, the core competence of cultivating lasting customer relationships can emerge from the judicious interaction of social skills (Human capital), an in-house Customer Database (Structural Capital) and a strong brand (Relational capital). An Enhanced IC Report therefore scours the indicators in the basic IC report to report on Core Competencies via combinations of intangible assets that generate value to the Customer. A sample of an enhanced IC report derived from the basic report presented in the previous section is shown below.

Core Competency		Intangible indicators grouped by Core Competency and Asset Type		Target	2007	2006
Produce world class automotive gears	Human	Percentage of sales invested in training		→	7.1	7.3
		Employee attrition (%)		↘	18	22
		Versatility Index		↗	93.7	94.5
	Structural	Percentage of sales invested in R&D		→	7	7
		Technical area Customer Satisfaction		→	4.5	4.4
2007	2006	Relational	Percentage of sales invested in marketing	↗	4	3.5
198.3	194.7					
Leader in industry collaboration	Human	Number of employees with external teaching assignments		↗	38	39
		Structural	Number of products that are industry certified		↗	8
	Number of papers published during the year towards industry standards		↗	38	26	
	Number of research projects in collaboration with partners		↗	3	1	
	Relational	Number of days on which company hosted industry events		→	29	26
		Number of industry events in which company participated		→	15	13
		Number of industry forums with representatives from Company		→	7	7
2007	2006					
138	119					
...

Phase 3 - The Model IC Report

The Enhanced IC report is clearly an order of magnitude improvement over a Basic IC report since Management can use it to continuously enhance the value creation process and investors can use it to discover value enhancing companies. Moreover, such an IC report should satisfy most of the requirements of the guidelines published by EFFAS, as shown in the box alongside. Nonetheless, Attainix Consulting believes that this is still not an ideal IC report. It is not enough for investors to know the value creation process and the core competencies behind them. Investors actually need to know the dollar value of the future cash flows that can potentially arise from such value. In other words, investors need to know the financial worth of these core competencies. Hence in this phase, companies need to value their Intellectual Capital. This is no doubt an inherently risky proposition, but no more risky than providing guidance and estimates as is the current trend.

What really helps the capital market

The ten EFFAS principles for effective communication of intellectual capital:

1. Clear link to value creation
2. Transparent measurement methodology
3. Standardization at sectoral and cross sectoral level
4. Consistency over time
5. Balanced trade-off between disclosure and privacy
6. Alignment of interests between company and investors
7. Prevention of information overflow
8. Reliability of the information disclosed and internal management responsibility
9. Assessment of the risks inherent in changes in indicators
10. Effective disclosure placement and timing

- *European Federation of Financial Analysts Societies (2008).*

(www.effas.com/pdf/effas_cic_web.pdf)

Attainix Consulting has developed comprehensive valuation algorithms that can be used for valuating the core competencies of the Company. Conservative companies may very well prefer to circulate the model IC Report only for internal consumption while disseminating the enhanced IC report for external stakeholders. That choice is entirely up to them. However, Attainix Consulting believes that investors can derive full value from an IC report and benefit from it only when complete disclosure is adhered to.

Summary

The IC Report is a document that companies need to publish along with their financial reports for the benefit of investors as well as for their own benefit. Attainix Consulting recommends a three phased approach for building an IC report. A basic IC report is a good starting point, but an enhanced IC report communicates more valuable information. The model IC report provides the maximum benefit to investors.

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.