

**The value
of Intangibles
to overcome
the systemic
crisis**

In collaboration with:

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The value of Intangibles to overcome the systemic crisis

Executive Summary

As suggested by several researchers, the bigger size of many firms (banks, insurance, and real estate companies, ...) particularly compared to that of Small/Medium Enterprises' (SME) has been a major cause for moral hazard² over the last few years that has driven them to excessive risk taking because they believed they were "too big to fail" and that Government intervention would in any case protect investors. Nevertheless, the SMEs cannot expect to receive similar Government rescue as a last chance. Such companies depend solely on their own strategies and must try to survive the ongoing crisis of the financial markets, of a whole business model and of regulation and control systems by relying on their own resources, most of which are intangible³.

Unlike many larger companies, which can usually rely on tangible assets such as property, plants and equipment, SMEs often have a larger amount of intangible assets that are identifiable and carry a specific economic value but remain nonetheless invisible in the financial statements: according to the most important international sources and conventional schemes, these assets are represented by human, structural and relational capital.

Each entity owns / has access to intangible assets that fit into all of the above three categories although one of them may often be more significant than

the others, depending on the company's business model and/or sector, and only their mutual relationship can represent a significant value driver to market competitiveness - a distinctive feature vis-à-vis other competitors - and can play a strategic role for growth⁴.

However, a more in-depth analysis reveals a quite different situation, which is almost a paradox for the recognition of their value, which often remains unexpressed in traditional accounting reports. In this scenario, the contribution of Intellectual Capital to corporate success is indeed partially evaluated and the strategies of management are often not explained in the financial reports. Furthermore, little emphasis is placed on the risks resulting from the inability to identify intangible assets or, even if properly identified, to manage them and achieve a continuous accumulation and improvement.

The recent events in the financial market have shown that intangible assets may become intangible liabilities which cause a value erosion in terms of reputation, higher transaction costs with stakeholders, lack of attraction from investors and lower market penetration of products/services.

Such risks can therefore be defined as the negative impact that unpredictable events have on the targets of an entity, namely the possibility of losses due to uncertainty over the achievement of corporate targets.

Although the literature argues that 70% or more of the market value of a company as well as its sustainability and future ability to create wealth are directly linked to these resources why have intangible assets only rarely been considered and appreciated at least to mitigate the negative impact of the current systemic crisis which caused the collapse of so many entities?⁵

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¹ Commission Recommendation - 2003/361/EC, "...have between 10 and 249 employees, a turnover up to € 50 mm and total assets up to € 43 mm".

² The term "moral hazard" comes from the insurance sector. Policy holders can sometimes be led to hazardous behaviors if they think insurance companies will be unable to verify potential fraud or negligence.

³ For further details see M.Moberly and J.P.Cheon, "Use Intangible assets to weather the financial crisis" Intellectual Asset Management Magazine, January / February 2009.

On one hand this phenomenon can be explained by the fact that many companies still have to implement a clear management and disclosing strategy of this type of resources and are afraid of disclosing confidential information about their competitive advantages. On the other hand, while knowing these issues, institutional investors, private equity fund managers and financial analysts, as well as analysts of Socially Responsible Investments (SRI) do not perceive the analysis of intangible assets as a key factor to strongly guide their investment decisions and, moreover, little attention is placed by the business media on this subject.

Managers still tend to overlook the importance of intangible assets as a major source of corporate value and for the successful leadership and management of companies, especially in this period of systemic crisis where decision makers are less likely to express interest in intangible assets when their company could be one of those facing financial collapse and therefore they do not realistically consider

them worth using, nor do they give them high priority among the measures to be implemented to monetize them and to obtain additional value.

Intangible assets are therefore underestimated in the establishment of corporate strategies and there is often a lack of consensus on the definition of standard non-financial indicators by sector to measure them. In times of economic prosperity it is hard to list the issue of intangibles among the priorities of CEO/CFOs, it is thus clear that this is even harder when a company is in a downsizing and cost cutting phase, when it is reconsidering marketing strategies and outsourcing processes, with banks cutting down on lending⁶. In spite of the above circumstances, we believe the current systemic crisis is boosting attention - not only in the academic environments but also on a professional level - on how to use and monetize those intangible assets that are increasingly essential for a company's corporate value, its profitability, market position, competitive advantages and sustainability in general. Indeed, it has become relevant for managers to:

1. identify the potential intrinsic value of these resources;
2. maintain control of the competitive advantages that can be attributed to intangible resources and the ability to seize their value. This is a top priority to get out of the current systemic crisis.

Indeed, the time has come for CEO/CFOs, General Managers and people in charge of business units to identify internally-generated and externally-acquired intangible resources and to determine how they can better be managed, exploited and monetized

so as to soften the negative impact of the current financial crisis.

I. The origin of the project

This research project is sponsored by the AIAF Working Group "*Mission Intangibles*"⁷ in cooperation with BilanciaRSI⁸. Starting with an analysis of the systemic crisis that led to the collapse of a large number of companies and considering the evolution and impact of intangible assets and liabilities in the current economic-financial scenario, both in terms of markets and of individual companies, the project is to pursue two priority goals, namely:

- stimulate companies to engage in processes for the identification, management and disclosure of intangible assets;
- provide a substantial contribution to encourage institutional investors, private equity fund managers, venture capitalists and financial analysts to consider the analysis of corporate intangibles as an opportunity and a new and powerful incentive to expand the return on investment strategies by identifying the best mix of intangible assets fitting each sector and which are likely to generate extra financial returns⁹.

Following a consolidated axiom proposed by Tom Peters¹⁰, who insisted that only "*what gets measured gets done*", in traditional reporting systems decision makers usually focus primarily on tangible assets, whereas intangibles are often overlooked in light of the fact that they can hardly be measured and checked because of the several restrictions imposed by accounting principles on the reporting of internally

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⁴ T. A. Stewart, (2002) "... a three-star restaurant is successful mainly because of the human capital embodied in its chef, a franchise such as Burger King relies on the capital structure of its recipes and proceedings, a small local restaurant is successful thanks to its customer capital - the waitress calls you by name and knows that you like coffee no sugar with a dash of milk".

⁵ An analysis carried out by M. M. Blair shows that in 1982 the percentage of tangible assets of industrial companies consisting of real estates, plants and equipment was 62.3% of their total market value but that ten years later this figure had already dropped to 37.9%, highlighting a situation whereby over 50% of the capital invested by a company was in intangible assets although their value often remains undisclosed in the company's Balance Sheet (M. M. Blair (1995).

generated resources¹¹, nor they be used as collateral in funding transactions.

As for the specific features of intangible assets, this kind of approach apparently prevents decision makers from identifying the most appropriate strategies to support the current upsurge from the systemic crisis, because current measurement and assessment methods widely lack accuracy and standardization in themselves, unlike those adopted for tangible resources. It is therefore essential for what is immeasurable to become measurable by identifying the characteristics the new metric and non-financial indicators should possess to be considered useful also by institutional investors and financial analysts¹³.

Once intangible resources have been identified for each economic sector, corporate managers will have to find answers to the following questions:

- Does the company optimize the use and control of such resources?
- What is the relationship between intangibles and corporate risks?
- What value can be assigned to these resources?
- How can they be disclosed to the market?
- What are the standard non-financial indicators for each sector?

The assessment of intangible assets and the implementation of specific strategies can reduce huge losses of competitive advantages and also serve as a practical (and not only theoretical) basis to achieve greater sustainability through the sharing of goals in joint ventures, cooperation agreements, partnerships and networking between

companies. In light of the above, the following activities are under discussion based on a method of analysis proposed by M. Moberly and J. P. Cheon¹⁴ and are presented below:

1. *strategic planning of intangible assets* - the traditional patterns for the strategic planning of business processes tend to focus primarily on corporate tangible assets, while often neglecting intangible resources. It is time to include such resources in strategic planning processes so as to draw out the value that can be attributed to them while keeping their control and the possibility to use them.

The planning process should:

- generate awareness of the importance of intangibles in programs relating staff selection, training and employee evaluation;
- include monitoring activities aimed at insuring that the ownership, use and control of intangibles are subject to periodical assessment and disclosure;
- develop a corporate map of relevant intangible assets (generators, positioning, value, links, contributions and functions) thus avoiding to spend time and money trying to support assets that have already proved definitely damaged, obsolete and/or depreciated;
- include long-term, non-financial metrics in executive compensation plans and submit them to the compensation committee.

2. *assessment of intangibles* - In order to achieve an effective strategic use of intangible assets it is necessary to define an assessment procedure that should not be regarded as a mere

review of the sole intellectual property. It should rather be a structured activity to identify the intangible assets, the accumulation/exhaustion processes and the implementation processes whereby companies are able to bring out hidden value drivers and

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A similar survey carried out by Prof. Baruch Lev at the New York University in 1999 shows that this trend has intensified because the average value of the market to book ratio of companies in the S&P 500 index (total market value divided by book value meaning the value of the physical and financial assets less liabilities resulting from the financial statements) stood at 6.25. For hightech companies this ratio is even higher (B. Lev, "Knowledge and Shareholder Value", <http://pages.stern.nyu.edu/~blev/> January 2000). The same survey repeated by Prof. Baruch Lev in March 2001 shows that the relative impact of intangible assets, totalling 83.3%, is subject to a decline because of the implosion of the new economy bubble, though remaining very high (B. Lev (2001) Kaplan and Norton show that in 2002 the impact of intangibles on the stockmarket capitalization of companies was 75% (R. S. Kaplan, D. P. Norton, 2004).

⁶ For further details pls. see note Nr. 3.

⁷ **Mission Intangibles**[®] is a working group of Aiaf (Italian Association of Financial Analysts) whose responsible is Andrea Gasperini whose goal is to lead, motivate and stimulate critical discussion on the methods to measure, assess and disclose intangible assets and to exploit intellectual capital.

⁸ **BilanciaRSI**[®] is a Centre for Studies on issues related to Corporate Social Responsibility (CSR) and Sustainability, whose responsible is Andrea Casadei, integrating different experiences and skills to support the creation and the development of corporate value in the long term. Website www.bilanciarsi.it.

⁹ A. Gasperini and G. Fasciolo, "Le risorse intangibili nelle strategie di asset allocation" Rivista Controllo di Gestione, Ipsoa, July 2009.

¹⁰ Tom Peters, "Thriving on Chaos. Handbook for a Management Revolution" HarperCollins 1987.

¹¹ IFRS 3, IAS 36 and IAS 38.

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N.Kossovsky P. Gerken	Intangible Assets Lost in a Crisis – Quantitative analysis of sample banks	Executive Secretary of the Intangible Asset Finance Society - IAFS Senior Vice President with Steel City Re	USA USA
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M. Adams	The IC Crisis: An Open Source Manifesto	Co-founder of I-Capital Advisors and Trek Consulting	USA
S.Thévoux - Chabuel	Identification of Intellectual Capital in the Telecoms sector	SRI analyst at ODDO Securities	France
C. Duerndorfer	Extra-Financial Evaluation during a systemic crisis	Partner at The Value Group GmbH	Germany
R. Bordogna	The effects of the crisis on the prevailing economic paradigm: ENI's response.	Sustainability Reporting Manager at ENI SpA	Italy
G. Papiro F. Mereu	The Montepaschi Group's approach to the strategic management of non- financial intangible assets	Head of Business Development Monte dei Paschi di Siena Head of Corporate Social Responsibility Monte dei Paschi di Siena	Italy Italy
C. Daverio	Restructuring: it is time to think differently!	Coordinator for the SRI research activities in Italy of VIGEO'	Italy
M.P.Marchello	The Corporate Social Responsibility and Intangibles Relation within the Financial Markets Crisis	Programme Officer Forum per la Finanza Sostenibile	Italy
K. Królak- Wyszyńska	Stop counting what doesn't count! Focus on future value driver	Partner at Innovatika	Polen
P. Hofman- Bang	It's never to late to learn	VP Strategic Alliances Actcell Intellectual Capital Corporation	Japan
L. Pyis J. G. Claeys	AREOPA's observations about the actual situation of systemic crisis	Founder & President AREOPA Group Int. VP Global Operations AREOPA Group Int.	Belgium
L. Sforza	Overcoming the Crisis: Rewarding Human Capital Development for Sustainable Business Performance	Head Research and EU Affairs, Hewitt Associates	Belgium
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consolidate their competitive advantages.

Under a procedural viewpoint, an assessment activity should not strictly reflect a vision that has been predetermined or processed as a general framework. On the contrary, such an activity should include a flexible inquiry system that is to identify the knowledge management processes that are the basis of competitive advantage, that is, the various areas where intangibles are generated internally rather than acquired externally.

The management and control of intangibles should be proactive and not be delegated to people lacking proper understanding of their contribution to corporate productivity and profitability.

The assessment of intangible assets should pursue the following targets:

- identify intangibles that are the basis of a company's core skills, mission and vision;
- define the most efficient strategies to use such intangibles and the immediate operational steps to exploit them;
- mitigate the risks that may increase the vulnerability of these resources, whose assessment is often still based on personal opinions, while several metrics express values only at a given time, providing decision makers with little additional information to mitigate uncertainty;
- evaluate the impact of *self-fulfilling prophecies*;
- link information on intellectual capital with specific risk factors and the internal system of risk management.

3. *disclosure of intangible assets* – through an appropriate “Tableau de Bord” the CEO/CFO and Senior Management should identify a set of standard non-financial indicators so as to be able to:

- make an accurate assessment of the intangible assets upon which the creation of value depends, that is, they must be able to manage such resources;
- evaluate the contribution of intangible assets to the overall value of the company, to its turnover and future wealth and - together with its image - to its reputation, brand, relational capital as well as to its ability to attract human talents, in other words to the sustainability and profitability of corporate processes;
- estimate the impact of processes, products and services on natural resources in terms of environment protection and of those relative to safety and health at work, the respect for human rights and participation to the community¹⁵;
- disclose the contribution of intangible assets to the corporate business model and understand how they can best be used to draw out as much value as possible.

In order to provide a more pragmatic view of the targets of the present research, we report the experience of a few “*thought leaders*” on the issues of intellectual capital and that of entities having a longstanding background in value creation¹⁶.

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¹³For several years the European associations of financial analysts have been investigating the importance of intangible assets for their job. In 2006 they joined forces under the coordination of the EFFAS (European Federation of Financial Analysts Societies) and formed a special committee called CIC (Commission on Intellectual Capital) which in 2008 developed ten principles that should be followed for an effective disclosure of intellectual capital. These principles describe the characteristics of the indicators of intangible resources, specified for each target sector in order to be really useful to the financial community. EFFAS Commission on Intellectual Capital (CIC), “*Towards Valuation, Measurement and Disclosure, Principles for Effective Communication of Intellectual Capital!*”, website: <http://www.effas.com>. Andrea Gasperini, representing the Italian Association of Financial Analysts (AIAF), is a full member of the CIC commission for Italy.

¹⁴This method of analysis was drawn from M. Moberly and J. P. Cheon, “*Use Intangible assets to weather the financial crisis*” *Intellectual Asset Management Magazine*, January / February 2009: pls see this publication for further details.

¹⁵The 30 OCSE countries and other 12 non-members countries have currently signed the “OCSE Guidelines for Multinational Enterprises” These guidelines are a relevant contribution to the process at work by stating the principles of responsibility for a sustainable management of the enterprises. The Italian government also signed the OCSE guidelines and constituted the national contact point (punto di contatto nazionale www.pcnitalia.it) with the Minister of Economic.