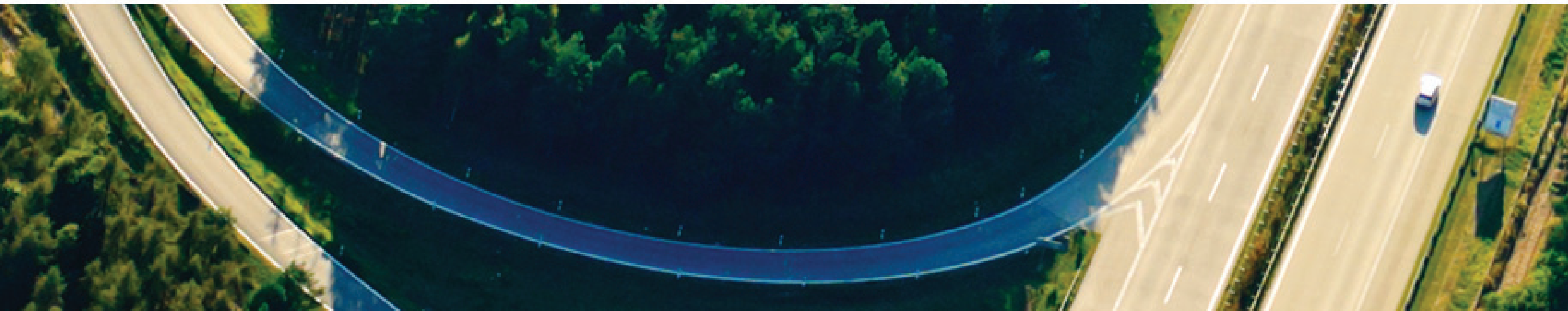
The Association of
Accountants and
Financial Professionals
in Business

Unrecognized Intangible Assets

Identification, Management, and Reporting



The Association of Accountants and Financial Professionals in Business

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Table of Contents

EXECUTIVE SUMMARY

Intangibles are those assets that are not physical in nature. They fall into two categories: those that are "recognized" and have an attributed value in the financial statements and those that are unrecognized for financial reporting purposes.

This Statement on Management Accounting (SMA) focuses on the growing impact of the unrecognized portion of intangible corporate assets. These items have grown to become a major source of value to public corporations. They contribute to competitive capacity and they form a critical aspect of an organizations' sustainability[1] into the future. While these type of assets fail to meet the criteria for recognition under current reporting standards, the identification, assessment, management, control, retention, and nurturing of these assets is necessary for an organization to maintain its capacity to operate.

Typically, statutory reporting lags that desired by stakeholders. Progressive organizations tend to assess their stakeholders' need for information and voluntarily disclose that which is "over and above the minimum required". Finance and accounting professionals, in their roles both as advisors to management and in ensuring the transparency (i.e., visibility to more detailed and support information) of external reporting, must be concerned with an organization's ability to remain a going concern, to compete effectively, and to protect its assets. This SMA identifies the importance and breadth of unrecognized intangibles and presents issues and concerns related to them. Various types of unrecognized intangible assets are discussed and approaches to managing and reporting these assets are suggested.

Key Words: knowledge; intangible; intangible assets; intellectual capital; goodwill

1 In the general literature, the term "sustainability" can have two meanings: (1) the economic survival or "viability" of an organization, and (2) achieving economic and social development in ways that avoid destroying or depleting natural resources or polluting the environment. As argued later in Section 9, the two concepts are related.

2 INTRODUCTION

The great crash in the 1920s that affected the United States and many other industrialized nations, followed by the recovery in the 1930s, brought with it tremendous changes in corporate accountability. Publicly-held organizations were required to disclose a much broader range of financial information; standards were developed that created defined frameworks for reporting; audits were required to ensure compliance. Since that time financial reporting has continued to evolve to meet the needs of external as well as internal users.

The 1980s and 1990s saw an increasing pace of technological development that heralded the maturing of the industrial society and the emergence of the knowledge society. While the industrial society focused on the use of tangible assets to create goods and services and deliver value for investors, the knowledge society increasingly relies on intangible assets. Although these two "societies" overlap—traditional manufacturing organizations apply the newer concepts of knowledge management techniques to optimize the performance of tangible equipment—both types of organization increasingly deliver results from the effective harnessing, utilization, and development of intangible assets that no longer fall within the current framework of accounting rules and standards.

A number of initiatives have begun over the last 20 years that contribute to an increased concern and awareness of this issue. These have developed through three parallel tracks. Each track complements the others yet remains somewhat isolated in its adoption and application. The first track, dealing with existing frameworks and oversight accountability, is pursued by the accounting profession. Initiatives include the responses to organizational risk management in the 1980s resulting in the COSO framework; the enhanced business reporting initiative of the AICPA; and enactment of the Sarbanes-Oxley Act to improve public trust in the accountability of publicly-traded companies. There have also been initiatives at the nonstatutory compliance level that have influenced disclosure and reporting, including the development and adoption of techniques for broader reporting such as the balanced scorecard. Internationally, efforts have also included increased focus by International Federation of Accountants (IFAC) on the challenges of intangible assets and efforts to develop new reporting frameworks.

These efforts, however, have been limited by the reliance on existing frameworks for capitalization of assets and the difficulty in making intangible assets part of mainstream reporting. What has emerged as a second, parallel track of attention is an alternative and supplemental reporting approach that attempts to complement traditional disclosure by producing a broader base of organizational performance information. Many well known authors such as Baruch Lev, Leif Edvinsson, Karl Sveiby, and Thomas Stewart have contributed to the stream of thinking as to how to identify and report the value of intangible assets. Yet much of this work has failed to reach mainstream reporting, and it has not been embraced by the financial community.

The third track is the developing interest in the reporting of corporate social responsibility[1] (CSR). This area complements the issue of sustainability of intangible assets because of two main factors. First, an organization's public "value" is impacted by the perception of its behavior within society. In today's society, the public is increasingly prepared to discount the value of organizations that fail to implement management systems that address a company's environmental impact and social behavior. One only has to look at many "brand name" U.S.-based global corporations to see the speed at which attitudes have changed in addressing such issues. Complementing this is the growing necessity for organizations to pursue initiatives in the area of "sustainable procurement." A second impact is at the investment community level. Socially responsible investing (SRI) is a growing approach through which money managers have expanded their due diligence efforts as well as their shareholder activism towards those organizations that fail to demonstrate an appropriate level of attention to the environment and social responsibility. Growth in such attention will in time result in lenders demanding a risk premium for those borrowers who fail to implement management systems to address these broader aspects of behavior. No investor wants to be surprised by the occurrence of another Exxon Valdez .[3]

[2]The accounting profession is a key player in the world of both internal and external accountability and has a public role in ensuring responsible stewardship of investors' portfolios. As such, it must be a strong con-

2 CSR or Corporate Social Responsibility is an approach through which an organization expands its public accountability to include performance relative to all key stakeholders (for a broader definition see Wikipefia et.al.)

3 The Exxon Valdez was an oil tanker that gained infamy on March 24, 1989 after it ran aground, spilling an estimated 10.8 million U.S. gallons of crude oil into the ocean off the coast of Alaska. This was one of the largest spills in United States history and one of the largest ecological disasters in history.

tributor to these emerging issues. Failure to do so will see it taking on the responsibility to develop and maintain standards and reporting that increasingly deal with a smaller and smaller share of an investor's value—not a prescription for a healthy and growing profession.

3 THE GOAL OF EFFECTIVE AND TRANSPARENT REPORTING

Reporting occurs for internal and external purposes. The goal of internal reporting to management focuses on the provision of information that facilitates effective operational decision making, in order to protect the organization's assets and capacity to function and to balance the optimization of short-term results with long-term sustainability. External reporting is typically of two types—that which is defined by statute for legal or securities regulatory purposes (mandatory reporting), and that which is discretionary and developed to provide information and communicate affairs of the organization to stakeholders in an open and transparent manner. The goal of statutory reporting is to achieve compliance; the goal of discretionary reporting is to provide key stakeholders with additional information that allows them to make informed decisions relative to their interests, accountability, and responsibility. Typically, statutory reporting requirements lag that desired by stakeholders. Progressive organizations tend to assess their stakeholders' need for information and voluntarily disclose that which is "over and above the minimum required".

Currently, there are movements affecting internal and voluntary external reporting in reaction to the shift of the global economy from the industrial society to the knowledge society. These can be expected to eventually also influence statutory reporting requirements. Statutory changes will take more time. In fact, the history of accounting standards and disclosure in the period immediately after the 1929 crash and since indicates that often a significant event has to occur in society before change takes place. Increased concern in the late 1980s centered on the apparent inability of boards of directors to be aware of the risks within their organizations due to an absence of or inadequate disclosure. This resulted in the development of enhanced risk management frameworks and the work of the Treadway Commission. In 2002, following a number of corporate scandals, including the collapse of Enron[3], passage of the Sarbanes-Oxley (SOX) legislation led to the improvement of corporate compliance and reporting. As a result of the 2008 global economic crisis, new regulations on financial institutions and governance agencies are likely to occur. To date, however, regulatory agencies have yet to deal with the challenge of accounting for corporate knowledge assets.

Notwithstanding the regulatory delay, questions about the adequacy of both internal and external reporting and disclosure began emerging as the shift to the knowledge era escalated in the 1980s. *Relevance Lost* (Johnson and Kaplan, 1987) asked the question whether internal approaches used for management accounting were any longer adequate: "Corporate management systems are inadequate for today's environment. In this time of rapid technological change, vigorous global and domestic competition, and enormously expanding information processing capabilities, management accounting systems are not providing useful, timely information for the process control, product costing, and performance evaluation activities of managers."[4] This book highlighted the substantial distortion of product costing using broadly averaging cost allocation factors that did not reflect the causality principle of accounting. It advocated activity-based costing as the practice to remedy this weakness.

This book was followed up by Kaplan and Norton's work, *The Balanced Scorecard* which made the point that corporate reporting needed to be expanded to include nonfinancial drivers of competitive success: "Today, organizations are competing in complex environments so that an accurate understanding of their goals and the methods for attaining those goals is vital."[5] For more than 20 years management has been moving towards new and broader information reporting systems.

The work of the Enhanced Business Reporting Consortium (EBRC) since 2003 has continued this discussion and focused on external reporting requirements. Prior to EBRC, several other approaches to enhance external corporate reporting had been initiated both by investors and by other interest groups—some acting

4 Enron was a major U.S. energy corporation that filed for bankruptcy in 2001.

5 Johnson, T. and Kaplan, R. *Relevance Lost – The Rise and Fall of Management Accounting*. Harvard Business School Press, 1987.

6 Kaplan, R. and Norton, D. The Balanced Scorecard, , Harvard Business Press, 1996.

directly on behalf of investors, the traditionally prime stakeholders and by third party organizations as well. All of these represent a growing level of concern over corporate transparency and visiblity. Corporations themselves, from shareholders to boards of directors, have been increasingly concerned over the perception by the public of organizations' failure to disclose certain aspects of corporate activity, particularly in the areas of environmental and social impacts. Achievement of the goal of effective reporting and transparency is thus being increasingly questioned internally and externally.

The Enhanced Business Reporting Consortium included the following as the focus of its efforts:

> Enhanced Business Reporting provides a framework structure around company disclosures that will give investors a more complete picture of companies—especially companies that rely heavily on intangible assets. The overarching objective of the EBR Consortium is to achieve the right mix of fully disclosed, high-quality information, made possible not only by adding critical information that is not currently disclosed (enhancement), but also by advocating for improvement in the consistency and relevance of existing disclosures, and in the communication focus of financial reporting as it stands today (simplification).

EBRC has joined in an international effort, the World Intellectual Capital Initiative (WICI), whose goal is to create a "global framework for measuring and reporting on intellectual assets and capital." (http://www.worldici.com/index.php)

4 INTANGIBLES AND THE EMERGENCE OF THE NEW ECONOMY

Threaded through the whole debate over transparency and visibility has been the challenge of the decline in the relative importance that tangible assets play in organizational competitiveness and sustainability, and the rise in importance that intangibles play. This shift is related to the bigger trend of the shift from the industrial society to the knowledge society.

The knowledge economy started slowly over the course of the 20th century as more and more workers began working in white collar jobs dealing with information as opposed to blue collar jobs making things or growing food. [6] This trend accelerated after the invention of the computer mid-century and exploded with the advent of the Internet toward the end of the century. Beginning in the 1980s when the personal computer (PC) was introduced, more and more jobs in both the white and blue collar sectors began to rely on computers. This technology enabled information and knowledge to be captured and shared at a greater pace than ever before in the history of mankind. This explosion of information and knowledge came to affect almost every kind of workplace and job.

These business trends created a challenge for the reporting systems upon which our economic system is built. The easiest way to see this is through the growing gap between the market value and book value of the average corporation.

Until the 1980s, the valuation of a typical company was approximately equal to its book value. This made sense because a company's earning capability was strongly tied to its tangible assets—what it owned. From that point on, however, an increasing portion of earnings has been driven by a company's knowledge—what it knows. Even in manufacturing businesses that continue to rely heavily on tangible assets, the ability to optimize the performance of these assets is increasingly seen as being driven by the innovation and creativity of the workforce. While these kinds of knowledge assets can be extremely productive, they are invisible in traditional reporting and governance systems in place today that were, for the most part, developed for the industrial age.

The extent of this information gap can be seen in the annual "Intangible Tracker" published by Brand Finance, which reviews a large sample of the world's largest publicly-traded organizations. The EBRC's December 2007 report observed that some 75% of corporate value is now not reflected in statutory financial disclosure. Using traditional financial reporting meeting either IAS or FASB standards result in 25% of corporate assets being capitalized (the tangibles), plus a portion of the intangibles, such as patents, trademarks, and others that amount to about another 10% of total value. Thus, accounting disclosure deals with about 35% of what the market attributes to an organization as its value. Put another way, accounting disclosure today fails to explain 65% of organizational value. (See Exhibit 1.)

6 http://www.pbs.org/fmc/book/2work1.htm

EXHIBIT 1. BREAKDOWN OF GLOBAL ENTERPRISE VALUE (US$ BILLION, 2001–2008)

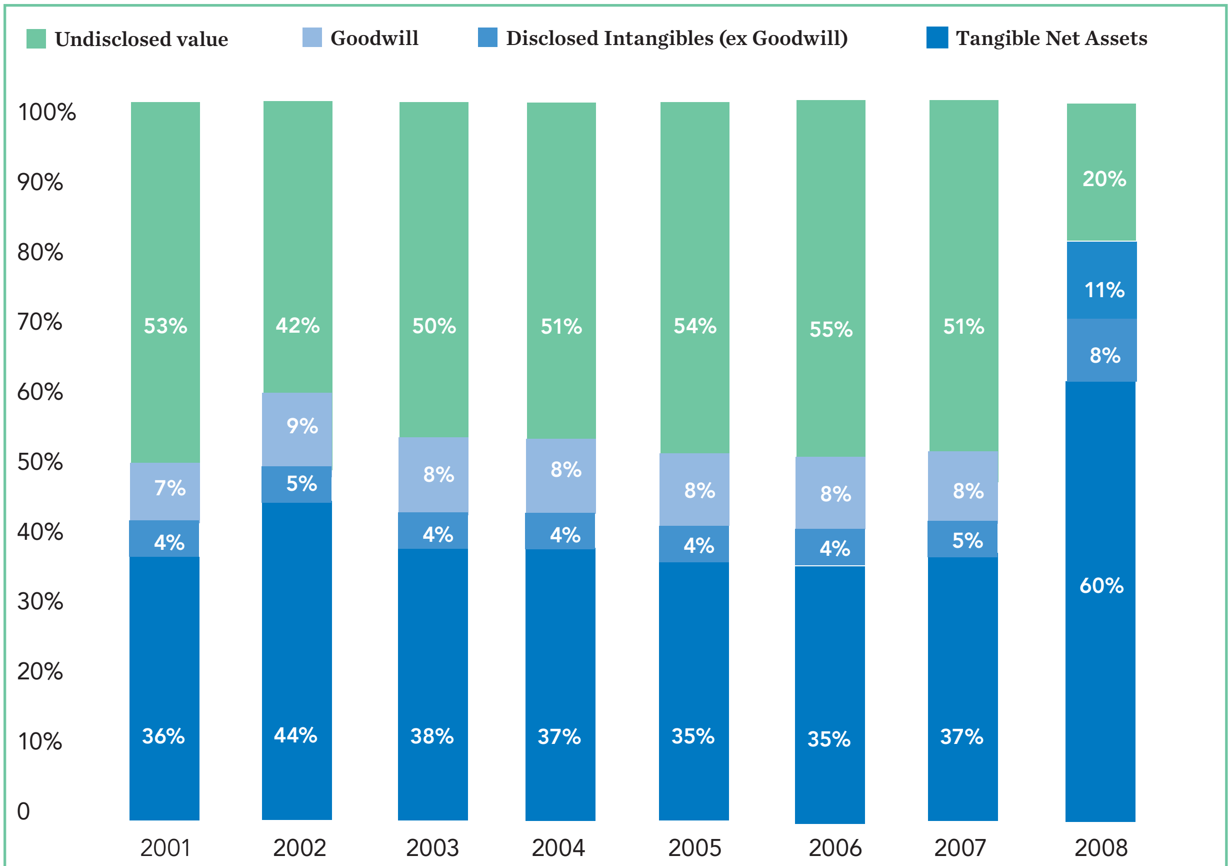


Chart reproduced courtesy Brand Finance "Intangible Finance Tracker 2009".

A similar gap is seen in a recent study by Ernst & Young[7] which examined 709 merger and acquisition transactions in 2007 worldwide. This study found that on average, only 30% of the purchase price could be allocated to tangible assets. Another 23% of the price could be allocated to identifiable intangible assets such as brands, customer contracts, and technology. The remaining 47% was booked to goodwill. Bottom line, this means that 70% of the average deal was attributed to intangible assets.

This increased value did not appear out of nowhere. To a great extent, the growing intangible value reflects investments that have been made over the past decades in computer systems, employee training, automated processes, internal and external networks, and branding, as well as research and development. In 1985, tangible investments exceeded intangibles by 40%. The two kinds of investments were roughly equal by 1995. By 2007, intangible investments were $1.6 trillion per year, 33% higher than tangible investments at $1.2 trillion.[8]

This information gap is recognized but has yet to be fully addressed. Historically, the need for changing approaches to accountability and reporting is driven by shifts in global economic and social conditions. Prior to the Wall Street crash in 1929, there were almost no standards for financial reporting, no need for independent audits, and minimal requirements for disclosure and transparency to the owners of capital invested in public institutions. After the crash it became apparent that new frameworks needed to be in place. What was created at that time is largely what we use today and what we are

7 Ernst & Young, "Acquisition Accounting: What's Next for You," February 2009. Available at http://int.sitestat.com/ernst-and-young/international/s?TAS_Acquisition_accounting_Whats_next_for_you&ns_type=pdf&ns_url=%5bhttp://www.ey.com/Global/assets.nsf/International/TAS_Acquisition_accounting_Whats_next_for_you/$file/TAS_Acquisition_accounting_Whats_next_for_you.pdf%5d.

8 Mandel, M. "The GDP Mirage," *Business Week*, October 29, 2009.

still trying to modify and adjust to make relevant to the newly emerging economy. However, the frameworks for governance that worked well in the past must be changed because they are no longer meeting the needs of a knowledge-based economy.[9] While traditional governance approaches focus principally on the protection of tangible assets and performance in financial terms the knowledge economy is based on the protection and nurturing of intangible assets as the key driver of current and future financial performance.

5 INTANGIBLES AND THE MANAGEMENT ACCOUNTANT

Many take the term intangible at face value—that is, these assets are unknowable and unmeasurable. Accountants, the argument goes, are responsible for fact-based financial reporting and only need to account for transactions that result from a tangible financial exchange. As an oversimplification, cash or obligations for cash (e.g., accrual accounting) are added or removed from the treasury bank account. However the more relevant issue is what kind of treatment management accounting should give to intangibles. To address this issue, it is necessary to look at the purpose and responsibilities of accounting.

Accounting serves several basic purposes in organizations:

- Keeping track of the organization's assets and liabilities. A balance sheet is the starting point for any accounting system. It records all assets and liabilities as well as reporting owners equity. Until the 1970s, the balance sheet adequately explained the value—the "book value"— of the corporation. As mentioned above the average balance sheet today explains only a third of this value. This is because intangibles are largely not capitalized (except in the case of a business combination), yet they are the drivers of the greater part of corporate earnings.
- Keeping track of operational movements. An income statement is a means of tracking all the operating transactions of the organization in the current year: revenues flow in, expenses flow out. In today's knowledge society the lack of capitalization of intangibles means that the income statement includes expenses related to both the current year and investments expected to yield a return over more than a year (training, building client relationships, innovation in processes, etc.). In addition, current year revenues include benefits that arise because of previous years' expenditures (investments in brands, relationships, etc.). A result of this is that the operating story available in the industrial era is lost.

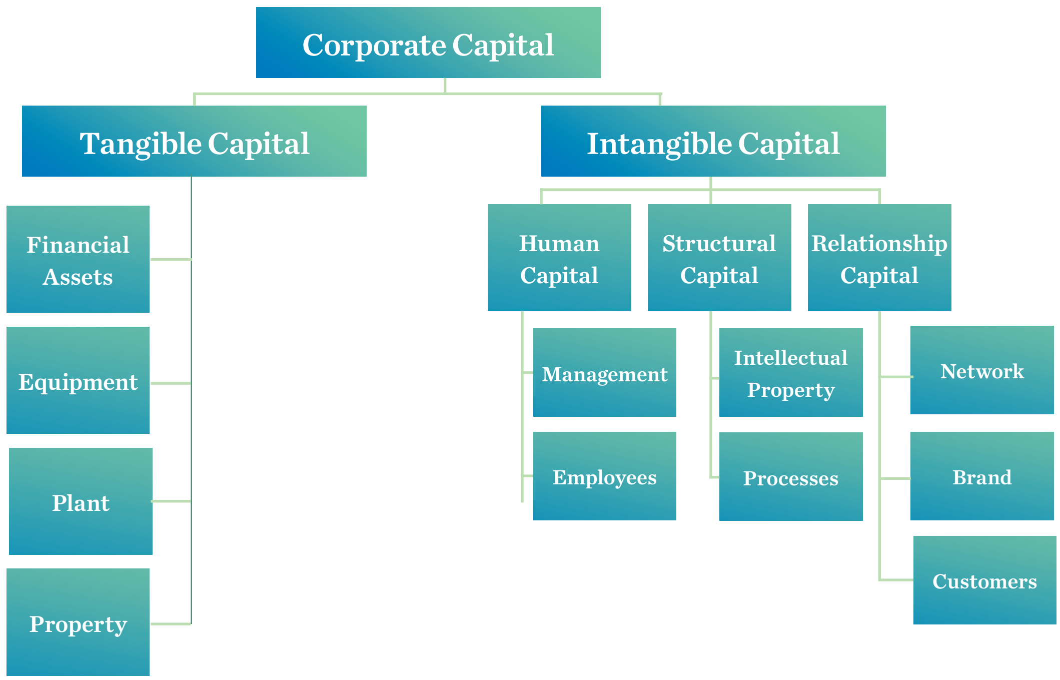
The statements produced by the accounting system can be used at any given date to check on the success of the organization's operations. Despite their shortcomings, financial statements are still used as the ultimate metric of the success of a knowledge-based organization, which is as it should be—the generation of positive cash flow is as critical in the knowledge era as it was in the industrial age. They may not tell the full story of how a company reached its result, but the financial statements (e.g., income statement, balance sheet, cash flow) can communicate the net "bottom line outcome" of financial success.

What the financials cannot adequately address today is the deeper question of viability. Industrial-era accounting could be used to explain the adequacy of an organization's assets and operations to help it meet its financial obligations. Auditors could use the financial statements to make a determination of an organization's economic capability to remain operating as a "going concern." Yet if the majority of the assets of an organization are intangible and off balance sheet, it may be difficult to make this analysis in a transparent and reliable manner. The only remedy for this is for accountants to develop objective data about intangibles that can be used for management reporting and analysis in order to support the continuing viability of an organization.

Many in the accounting profession remain happy with focusing on "outcome-based" measures of organizational performance. The investment community profession is less happy. The environmentalists are asking for more. The problem with an "outcome-based" measures approach is twofold. First, outcome measures are by definition lagging indicators. Using relationships as an example, when customers leave revenues will decline and sales expenses will increase as a percentage of revenue as salespeople have to devote a higher percentage of their time replacing customers who have left rather than attracting new ones. When this happens, however, the event is already over—it's too late! Management accountants need to monitor and report leading indicators that provide an early warning signal that the integrity of the intangible capital is being eroded *before* it shows up in the financials. Only through this can they provide value to management in protecting an organization's capacity to utilizing *all* of its assets.

9 Shepherd, N. Governance, Accountability, and Sustainable Development: A New Agenda for the 21st Century, Thomson Carswell, 2005.

EXHIBIT 2. TYPES OF INTANGIBLE CAPITAL



A second issue stems from the financial manager's responsibility for the protecting and sustaining an organization's asset base. While the marketplace assigns a value to a publicly-traded company that includes a premium over book value, the vagaries of this cannot be relied upon as a basis for determining an organization's actual performance in building and sustaining these aspects of its "corporate worth". Additionally, waiting until a value is determined at the time of a corporate sale (i.e., when goodwill is created) is not appropriate as it is akin to saying that the "premium assets" did not exist or were unimportant to understand, measure, and control until that sale took place.

We know the value of intangible assets is large; we know it is important, we know people are prepared to pay for it, and we know it can be created and destroyed. The problem is that under generally accepted accounting principles an asset is usually not recognized until an arms-length transaction between two parties has occurred, resulting in a large proportion of intangible assets not be recorded on balance sheets. Yet a new, complementary framework can be developed that allows stakeholders the transparency to assess whether this aspect of corporate value or capital is being enhanced, depleted, or destroyed—and whether existing management strategies are increasing the risk that competitive advantages, driven from this aspect of capital, might be evaporating.

6 THE TYPES OF UNRECOGNIZED INTANGIBLES AND THEIR IMPORTANCE

The intangible value that currently falls outside of statutory reporting can be divided into three major categories. (See Exhibit 2.) These have evolved from the model developed by Karl Erik Sveiby which initially covered human, organizational, and structural capital. We redefine these as the areas of human, relationship, and structural capital.

6.1 HUMAN CAPITAL

This first category must be positioned as the primary intangible, as through it most others are created and developed or destroyed. "People are our most important assets" is a phrase that has been in use for many years. The realization of the value of this capital has been there from an intellectual perspective, yet the ability to identify, understand, measure, monitor, and enhance the impact of this factor remains elusive. From the early days of the work of Frederick Taylor and his time studies, and through this the development of standard costing, the profession has created a good understanding of productivity and efficiency of the workforce when tasks could be clearly defined and measured and all that was required of "labor" was the ability to carry out the defined task within the time allowed. Economic changes have made this approach less valuable. The failure to adopt new management tools such as process thinking and new costing tools such as activity-based costing (ABC) has opened up a larger void in understanding "anticipated" versus actual productivity. Why is this hard to quantify using existing approaches?

- Far fewer people do repetitive work now as a result of the introduction of automation in the factory as well as enhanced process development in service and support organizations.
- Those who are involved in production are moving towards greater flexibility, and thus perform a variety of tasks, when organizations implement strategies such as lean and flexible manufacturing.
- Much of the workforce is moving to knowledge- and service-based employment in which, although there may be a process element (that can be costed), many of the tasks involve variability determined by the needs of the situation (client, project).
- In efforts to create a more participative, inclusive, and respectful environment, many people don't "clock in" or fill out time sheets today to account for what they are actually working on, so some organizations don't have actual "time usage" data.

Nowhere is this in greater evidence than the impact of information systems on human productivity. Many a CEO, CFO, or CIO is faced with "knowing" that movement to more effective enterprise management systems "must be the right thing to do," yet find it hard to develop hard numbers to either justify or later demonstrate the value of such an investment.

What we have learned is that an experienced, trained, and motivated workforce that is fully behind an organization's business mission can create the greatest competitive advantage an organization can have. What value do people create that gives rise to such an advantage, leading to enhanced financial performance and investors' value?

- They provide innovation and creativity that, given the right environment, lead to new products and services, plus innovative and creative ways to create and deliver such outcomes in the fastest and most cost-effective ways.
- They develop and sustain relationships that provide the basis of more effective supply chains (supplier relationships) and more effective sales and marketing activities (through enhanced client relationships and with others such as distributors and agents), leading to savings in both input and output costs.
- They create positive internal working relationships through "knowing the business" as well as having effective interpersonal skills that lead to enhanced interdepartmental activities, thus increasing cycle times and significantly reducing politics caused by lack of trust, collaboration, communication, and cooperation.
- They create structural capital (i.e., the capability and capacity to execute strategy), which captures knowledge of "best practices" of the organization and (even better) turns this knowledge into scalable, repeatable processes, often automated through technology.

The importance of human capital has moved to the forefront in a way that remains unnoticed by many. This is the area of corporate values and ethics. Actions that an organization undertakes, from the most senior executive down to the lowest level, have an impact on relationship capital. Legislatures can pass laws requiring ethical behavior and organizations can develop ethical codes, but ultimately it comes down to human behavior. An organization's market value will be protected and will grow over time if an organization's leadership and workforce sustain a high level of ethical integrity.

Much work has been done to try and value human capital, and several approaches suggest that monitoring areas such as average years of employment/experience may be a good indicator, as are absenteeism, training, and the number of professional degrees represented. This misses a key point. An organization may have the most modern equipment installed (i.e., capability), but without effective setup, maintenance, operator training, good tooling, etc., it will never provide a competitive advantage. Thus we need both the capacity and the ability to optimize the potential of this capacity. The same is true for human capital. An organization can have the most experienced and qualified people in the world, but if it fails to effectively motivate them by providing a positive and supportive environment, it will never optimize their capacity. Poor training, poor pay, poor communication, poor supervision, unfair treatment, and poor equipment, among others, can all be seen as contributors to this under-optimization.

Human capital needs to be thought of as both a balance sheet asset (what we have available to us) and as a driver of lower operating costs as seen through the income statement. Management accountants need to understand both assets and outcomes to effectively advise management on effectiveness as well as to be accountable to stakeholders on optimizing utilization of their company's assets.

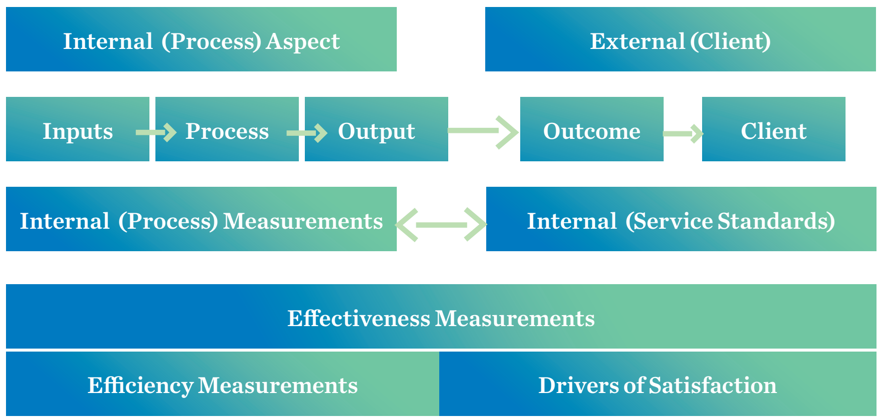
6.2 RELATIONSHIP CAPITAL

Human capital creates the second type of capital—relationship capital—which in itself creates significant value for an organization. This type of "asset" is capitalized when it is in the form of a client list. However, this example is like the human capital, example however—having a list (the asset) does not necessarily lead to a competitive advantage. Key to taking advantage of this and generating premium outcomes will be the level of client turnover being experienced as well as the level of satisfaction of the customer base. There are many interdependent relationships both inside and outside an organization. Consider these examples:

- Buyers are under pressure and need their suppliers to be part of more effective supply chains. Expectations today for effective relationships include low prices, error-free performance, continual innovation and creativity to reduce costs in all areas. Building such relationships takes time and cannot be developed by constant "price shopping".
- Positive "win/win" relationships with suppliers, developed over a long term, can lead to savings in both products and services acquired as well as administrative processes, which link the two parties. Effective supply chain management can only take place when the parties work together as partners for mutual benefit. This means that price must be but one of the factors. One could use as an example the relationships developed with suppliers in the automotive industry, comparing the approaches of Toyota and Honda with that adopted by General Motors.
- Treating customers as "assets" and thinking about the value of the relationship versus each individual transaction can lead to problem-solving approaches that enhance the relationship rather than terminating it.
- In many cases, an organization's community (often more than just its customers) becomes a critical asset. Examples include referral networks and the users of Google's search engine.
- In markets where repeat business is an opportunity, studies have shown a correlation between satisfaction and intention to re-purchase. Thus knowing and enhancing client satisfaction is a driver for the implicit value of the intangible asset called the customer base.
- In most businesses getting a new customer is more expensive than keeping an existing one (often by a 4:1 ratio). Lower client turnover leads to lower sales cost.
- Organizations are changing from a hierarchical model based on functional specialization to a "neural" model based on integration of all areas to create a knowledge base. Positive internal relationships remove barriers to the smooth flow of information across organizational boundaries, resulting in faster cycle times for decision making and lower incidence of "re-inventing the wheel" caused by people failing to share knowledge.

From a financial outcomes perspective, relationship capital leads to enhanced operating effectiveness, creating competitive advantage to which the marketplace assigns value. The importance of this area is clear when we consider that external parties assign value based on their observation of the way in which an organization

EXHIBIT 3. PROCESS CAPABILITY DRIVES RELATIONSHIP CAPITAL



functions. This can be based on either observation as a third party or through direct interaction with the organization. Emerging trends that reinforce this relationship side and link it to potential financial impacts include:

- Buyers seeking out more focused strategic relationships with those who have effective approaches to error-free operations (e.g., quality standards, such as an effectively implemented ISO 9001) and participative work approaches through which collaboration with suppliers is encouraged;
- The emerging use of expanded due diligence checklists in supplier evaluation that look at organization behavior in areas such as environmental commitment (using standards such as ISO 14001) and its social commitment (using standards such as SA 8000, especially in outsourced procurement in less developed countries, and the new ISO 26000 standard for Corporate Social Responsibility scheduled for release in the fall of 2010), in addition to competitive pricing;
- The emergence over many years of expanded due diligence checklists used by investors who have adopted SRI (Socially Responsible Investing) that look at risk management in building relationships with organizations that are not pursuing these approaches.

Relationship capital provides a key aspect of an organization's capacity to operate effectively. While financial markets often focus on outcomes from these capabilities, the rush to reduce operating costs in economic downturns can often lead to actions that destroy not only elements of human capital but, through this, relationship capital as well.

6.3 STRUCTURAL CAPITAL

The third area of intangibles is structural capital. While this is again created by human capital, it incorporates a broad range of capabilities that an organization possesses through which it goes about its day-to-day activity. It typically includes aspects of "manufactured capital" such as the ability, through human innovation, to develop "executional capacity" using high quality, low cost corporate systems and processes by which products and services are designed, developed, and delivered. In addition, this category would include areas such as unique capabilities that have been covered by patents, trademarks, and copyrights, and others that may to some degree have been assigned a carrying value in the financial statements.

The best examples of structural capital can be seen in organizations where "the process is everything." Several years ago the term "flawless execution" was developed, which has since been further refined and focused on as a key corporate strategy. In addition, attempts to enhance relationship capital by developing and committing to "service standards" have led many organizations to the realization that internal process capacity is the driver of any capability to commit to and meet external service standards. Exhibit 3 provides a schematic overview of these relationships.

It has been estimated by those involved in process re-engineering that between 75% and 90% of an organization's resources are spent in process activities—converting inputs to outputs. While in manufacturing this reflects converting a tangible (material) input to a tangible (product) output, the concept is exactly the same in service organizations. The only different piece is the tangible input and tangible output—although one might argue that a service such as a "delivered parcel" or a "paid insurance claim" is in fact a tangible outcome. The key is that effective cost control (i.e., competitive advantage) and dependability of output (reliable supplier) depend on the effectiveness with which this whole value stream works. Thus, organizations that have invested in developed and sustained effective and reliable "execution capacity" have been able to demonstrate a higher potential to develop earnings and therefore have been afforded a higher value in the marketplace.

Take FedEx as an example. Its financial balance sheet includes sorting centers, trucks, airplanes, and many other tangible assets that have been acquired as part of the capacity to execute; however, the most critical asset is not on the balance sheet. This is the organization's ability to sustain a process that links all these aspects together and is capable of delivering "before 10:00 a.m. the next business day." The reason people choose FedEx is not that it is cheaper than the parcel service; it's because FedEx is reliable and has a service guarantee. Process also has great importance in corporate support activities such as those managed by finance, compliance, human resources, supply chain management, and legal departments.

Organizations face some key risks in sustaining this aspect of intangible assets in the years ahead, the greatest of all being the impact of demographics and retirement. How much of an organization's "capacity to execute" rests in the minds of the workforce? Progressive organizations are developing codification systems (i.e., methods to turn intrinsic knowledge into extrinsic knowledge through documentation and sharing) using effective process management tools and employee training so that this knowledge "asset" can be retained and passed on to the next generation. Yet it's about more than the process, and this is where the importance of effective knowledge management will be key. We will use an example to demonstrate this.

> A large national taxation body was facing a major increase in retirement over the next eight years, particular in the audit function. While work had been completed to define the process of audit planning, execution, reporting, and follow-up, with all the necessary activities and tasks, little thought had been given to the knowledge developed by the auditors themselves in carrying out audits on specific types of industry. How did they know what to actually look for? The answer was, "It's all based on experience." After asking how this knowledge was being passed on to the new auditors, it was realized that a mechanism was not in place to codify this aspect of the knowledge. The result was the development of a whole series of "tips and traps" developed with the experienced auditors whereby they identified their experiences over the 30 years of auditing in a specific industry.

Many organizations depend upon their employees to use their experience to deal with any given "non-routine" situation. How is your organization passing this on? Without it, a key element of capacity to execute will be lost, which can result in declining competitive advantage and increased costs.

Capturing prior to employee retirement this aspect of competitive advantage is important. Who knows the business and how the work is done? The people actually doing it! An organization that has the capacity to innovate and continually improve its executional capability will sustain and grow its competitive advantage. Readers of *The Toyota Way* (Liker, 2004) see that key to success is both a focused approach on the development of executional capacity combined with a continuing commitment—every minute, every hour, every day—to changing this and improving it in small ways. In a rapidly changing and competitive economy, the organization that has fostered a culture of innovation and creativity will have a major competitive advantage leading to enhanced value to the investor.

7 THE CHALLENGE OF ACCOUNTING FOR INTANGIBLES

Knowledge as an economic asset has distinct characteristics that distinguish it from tangible goods. Thus, although intangibles are important to the 21st century organization, there are a number of barriers to incorporating them into existing economic and accounting paradigms.

Knowledge is not a finite asset. This contrasts with tangible assets. If a company owns 100 products and sells 10, it is left with 90. By contrast, when a company owns a knowledge product (such as software), selling a license to that software does not diminish the "inventory" of software. If the software is sold via a CD, the inventory of CDs may go down, but the more important inventory of knowledge does not decrease. In fact, many knowledge assets such as software [10] increase in value as they are used. A large community of users of knowledge contained and managed through effective software makes the software more valuable to each incremental new user. Traditional economics and accounting are built based on an assumption of scarcity. In contrast, knowledge economics is sometimes called the economics of abundance. Accounting cannot measure abundance. It is unrealistic to expect that accounting will ever measure abundance. The fact remains, however, that businesses today do invest in intangibles and realize a return on these investments. In designing approaches to measuring this activity, there are several challenges for the field of accounting.

First, many intangibles are not directly controlled or owned by the organization to which they are contributing knowledge. Control implies the ability of the organization to capture the future benefits generated by an asset. Many aspects of human capital and relationship capital are not controlled by the organization, although contracts with specific employees or partners are sometimes recognized as owned assets. Structural capital is generally controlled by the organization that built it.

Second, most intangibles are developed internally. To be recognized for financial accounting purposes there must be a financial transaction involved. Interestingly, as described in the next sections, there are financial transactions associated with the development of many intangibles have to do with investments in developing intangible capacity that potentially could be brought into the accounting system.

Third, many intangibles are integrated with other intangibles and are difficult to separate. Accounting requires that assets be identifiable and separable. This means that they must be capable of being separated and sold, transferred, licensed, rented, or exchanged. [11] Again, with increased understanding of intangibles, some kinds of structural capital, especially processes, could eventually be brought into accounting.

10 Software is used as an example because it is created by knowledge workers but also serves as an enabling tool for converting data into knowledge through effective analytic and simulation techniques characterized by speed and accuracy that could not be achieved manually.

11 This requirement can be found in IAS 38 Intangible Assets, paragraph 12. This standard also lays out many of the other basic principles used today for recognition of intangible assets.

These challenges mean that it will not be easy to fully incorporate intangibles into existing external reporting standards. Yet management accountants can and should develop competencies in tracking intangibles through internal reporting.

8 THE REPORTING OF INTANGIBLE ASSETS

The Institute of Management Accounting (IMA) defines management accounting as:

> "… the internal business-building role of accounting and finance professionals who work inside organizations. These professionals are involved in designing and evaluating business processes, budgeting and forecasting, implementing and monitoring internal controls, and analyzing, synthesizing, and aggregating information—to help drive economic value." [12]

In this role, management accountants frequently use the basic information contained in the financial systems to support decision making. It is in this capacity that management accountants can and should begin to develop better information about their organization's intangible assets, regardless of external reporting standards. There are four basic kinds of information that can be developed and tracked.

- Inventory—To account for intangibles, you need to start in the same place you would with any new accounting system: take an inventory. This inventory should include a listing of all key assets. For human capital, the key items on the list are the core competencies of the organization. For relationship capital, the key items are key brands, key customer types, as well as supplier and partner relationships. For structural capital, it is the key business processes that help create customer value. For example, the key processes in the Google search business are the search process and the advertising process that funds it. Every business also has support services that include finance, human resources, legal, etc.
- Investment—Once you have an intangibles inventory, you need to start keeping track of your organization's annual investment in these intangibles. This investment is currently reported in an income statement account. You are not going to change that reporting methodology; but rather keep a separate management report. The standard for including an "expense" as an "investment" is the same as

12 http://www.imanet.org/about_management.asp

it would be for a tangible asset: spending that is expected to yield value beyond the current year. A good example of this would be the design and implementation costs of a new supply chain system—spending on the process itself (structural capital), links with supply chain partners (relationship capital), and training of personnel in the use of the system (human capital).

- Assessment—Assessment is the least familiar concept to accountants but one that should not be ignored. Assessments are frequently used in business to evaluate personnel (Myers Briggs or 360° assessments), customer service, and employee satisfaction. But this tool can also be used to evaluate the health of the assets in the intangibles inventory. This can be done using a standardized tool such as IC Rating™ or through the creation of a company's own evaluation. The important thing is to ensure that an organization is asking these questions: Are these assets performing the way we expect them to? What is the outlook for these assets? Where are we at risk? This final question is the counterbalance, the liability side of the equation. These three kinds of information are similar to the kind of periodic information that is normally gathered for a balance sheet. These speak to the investment and viability of an organization's assets. This information is important as input into strategic planning and decision making and into the design of the final type of information: indicators.
- Indicators—Indicators are measurements that can be made on an ongoing basis to track the performance of an organization's strategy. Most accountants are already familiar with these as they have been popularized by the balanced scorecard and performance management systems. Indicators are often delivered via a dashboard or a quick reporting format. By definition, they do not measure all aspects of an operation, just the key performance indicators (KPIs) that have been identified as leading indicators of the performance of the organization.

Indicators can be very powerful, but they should not be used without the other three kinds of intangible information. Using indicators alone would be like keeping an income statement without a balance sheet—you know how you are doing moment to moment, but how are you doing overall? The knowledge era business needs both perspectives.

9 INTANGIBLES, CSR, SUSTAINABILITY, AND THE TRIPLE BOTTOM LINE

In parallel with the focus on intangibles within the accounting profession, complementary developments are underway in other fields, some of which financial managers may already be exposed to or involved in. These fall within the broad heading of "sustainability." Since Ben & Jerry's[13] published its first "social responsibility report" there has been a growing interest in nonmandatory, broader-based accountability by corporations over and above their financial performance. This reflects a growing understanding by stakeholders of corporations that financial performance that comes at great cost to society or the environment eventually affects the organization's own viability.

The interest in sustainability reflects an understanding that exclusively counting financial results skews the decisions made on an economy-wide basis. For example, GNP counts the sale of cigarettes but not the cost of related health consequences. In a like manner, GNP also counts the sale of automobiles and gasoline but not their effect on global warming. There is a growing realization that economic measurement must count on the impact at a macro level as well as at the micro level of the individual firm.

One of the forces driving this in the U.S. and the U.K. is the changing character of the shareholders of public companies. In these countries, the majority of stock is now held by individual investors or by their representatives (such as pension funds). These organizations are dependent on not only the success of individual companies but also the viability of the entire system. They do not want to see individual companies succeed in a way that puts the entire system at risk. [14]

There have emerged a variety of frameworks for such reporting that deal with issues such as environment, health, safety, community involvement, and philanthropy, which in some cases have also been incorporated into separate reports. In its March 2009 study of "report-

13 Ben and Jerry's is the now globally famous ice cream brand started by two forward thinking and innovative U.S. entrepreneurs and later sold to Unilver

14 *The New Capitalists: How Citizen Investors Are Reshaping the Corporate Agenda*, by Stephen Davis Jon Lukomnik, and David Pitt-Watson.

ing entities," Corporate Register [15] indicated that in 2008 over 3,000 organizations, including over 50% of the global FT 500 firms, were producing stand-alone corporate responsibility (CR) reports. In addition, more and more firms are moving to produce a report that focuses on what has been termed the triple bottom line—environmental, social, and economic aspects of corporate performance.

As social expectations change and organizations come under greater scrutiny, their intangible value will be impacted by the public's perceptions of how they operate.

- Human capital may be eroded as talented individuals decide not to join or not to stay with organizations that have not adopted broader accountability for their actions.
- Customers may decide not to do business with organizations that do not have environmental management systems in place.
- Investors may decide not to invest in or may demand a higher risk premium for organizations that do not have in place supplier audit and evaluation for their social performance when operating in less developed countries.

Reputation and brands form a key intangible asset for many organizations, and in particular these can be influenced by negative perceptions about corporate behavior. One of the actions taken by AIG [16] as a result of the recent financial meltdown was to change its name because of the negative aspects associated with continuing its use. How much investment had building this brand required? How quickly was this destroyed?

The linkage here for the financial manager is that awareness of changing societal expectations of organizational behavior and performance can have an impact on intangible values. Failing to embrace such changes until they are legislated can erode intangible value. The strategic impact of not responding may be far greater than the short-term savings that can be achieved by deferring such investments.

Financial managers should review the types of sustainability reports being developed and published through sources such as the Corporate Register and identify the types of measures and indicators that are being adopted in areas such as environmental and social reporting. These can provide valuable insight into the types of broad-based measures that may have possible application in developing a framework for intangibles.

10 CHALLENGES AND SOLUTIONS FOR DISCLOSURE

Addressing the issue of intangible valuation and reporting is a significant challenge and should be considered from an external and an internal aspect separately. External disclosure can create significant problems when analysis of such data might release information that would be detrimental to competitive advantage. External reporting should be based on caution. Much of the direction in this regard is best determined by aligning with the emerging area of CSR (corporate social responsibility). In this way an individual might assess the organization's effectiveness in responding to issues that impact reputation and brand values, as well as employee motivation. In most situations, disclosure in these reports addresses issues that have been determined to be important to key stakeholders through an engagement and review process.

More important are the internal reporting aspects, as these focus on what management and the board of directors should know about the organizational elements of intangibles within the asset base of the organization and the degree to which management is building or diminishing such value. This has become critical in recent years as senior leadership tenure has declined. Also, in many cases, executive compensation has been linked exclusively with financial goals, many of which can be achieved in the short term at the cost of a severe negative long-term impact on the integrity of the organization's intangible assets and its ability to sustain itself.

10.1 HUMAN CAPITAL DISCLOSURE

In the area of human capital, significant research is available to help develop strategies for protection and enhancement. As an example, the twelve core questions presented in the book *First Break all the Rules* (Buckingham and Coffman, 1999) provides areas where a company can assess its progress towards creating an environment that is conducive to optimization of human capital. In order to build a framework, the approach could include steps to:

- identify what attributes of human capital are key to business sustainability (experience, skills, qualifications/competencies, attitudes);
- evaluate the existence of such attributes within the organization's workforce (inventory of key skills and other items within the workforce);

15 Corporate Register has become a global repository on the World Wide Web that contains one of the largest collections of publicly reported CSR (corporate social responsibility) reports. See website in references.

16 AIG (America International Group) is a large U.S.-based financial insurance and re-insurance corporation that had underwritten many of the bad loans that formed part of the 2008-09 U.S. financial crisis. .

EXHIBIT 4. MOTIVATION—CONVERTING HUMAN POTENTIAL TO CAPITAL

**Human Capital creates Structural Capital
that leads to Customer (relationship) Capital
"..people are our greatest assets.."**

Capability + Motivation = Results

Capability	Motivation	Results
• technical abilities • years of experience • industry knowledge • tenure in company • level of learning	• turnover • absenteeism • survey results • pay levels • benefit levels	• client satisfaction • new products • new service • growth • fast cycle time

What is the correlation for Return On Intellectual Capital?

- Identify the linkages between capability and outcome (e.g., what attitudes lead to enhanced client satisfaction? What skill sets lead to higher individual productivity within job positions?) using tools such as self-discovery personality evaluations (e.g., "Insights"® and other "colors"-based systems), as well as leadership skills, emotional intelligence, and others;
- identify/benchmark outcome performance indicators such as client satisfaction and cycle times of processes in core competency skill sets;
- Assess the impact of employee satisfaction outcome levels and assess their economic impact on measures such as re-purchase intentions, process costs/transaction, and other performance attributes.

While this may seem a "loose" approach, it begins to offer alternative ways to link the value of effective human management and leadership to organizational outcomes.

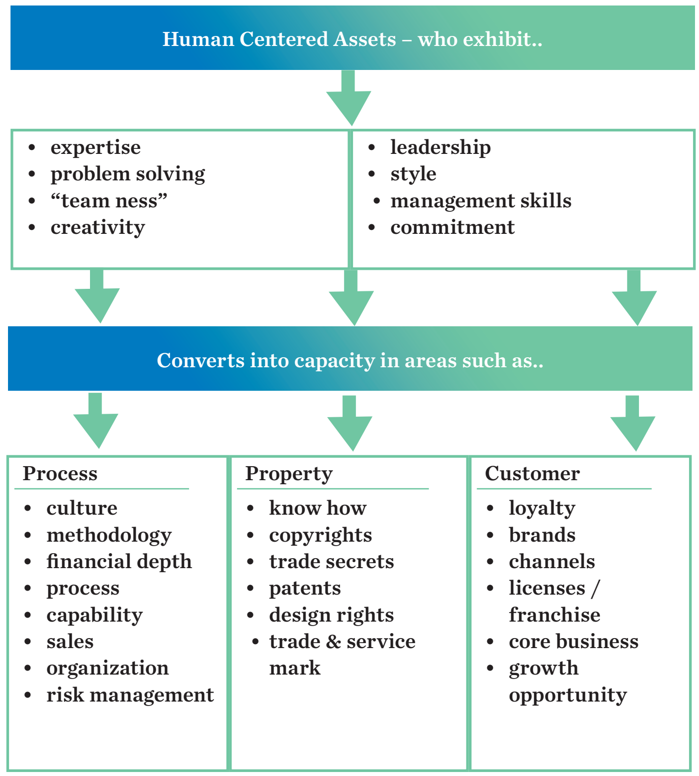
Exhibit 4 depicts the understanding required to assess the sustainability of the human capital base where the benefit is the return on intellectual capital (ROIC). It shows the following:

a) Human capital creates almost all other aspects of intangible capital, so its protection and development are key;
b) Capability of the workforce (the asset) is key in terms of "what we have"; however,
c) The environment that is created determines whether the asset is "turned on" and operating effectively;
d) The real value of the human asset base is in what the outcome is; and
e) Effective management of "b" plus "c" defines the competitive advantage created in "d," which ultimately creates greater organizational value through capacity to operate.

Effective metrics for intangibles, especially in the human capital area, require that we know what "assets" we have and, more importantly, know the impact on outcomes that these "assets" create in terms of creating competitive advantage. Two organizations may have equivalently qualified group of employees, but differences in motivation can result in very different outcomes. Both the existence of the intangible asset and the outcome from having it are important.

Managers and board members who seek improved financial performance through cost cutting may well be missing the negative impacts that achieving such cost reductions may be having. History has shown that organizations that focus on sustaining employee well-being

EXHIBIT 5. ASPECTS OF HUMAN CAPITAL



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through recessions generally come out of such downturns stronger than those that "just cut costs across the board." One can argue that the success of Wal-Mart may well be linked to the fact that in the recession of the early 1980s, it focused on completely redesigning its supply chain and cutting "back office" process costs rather than cutting staff at the customer-interface portion of the organization. Others in retail maintained a "business as usual" approach and lost customers due to poor service caused by inadequate numbers of staff and a lack of experienced staff. Wal-Mart revolutionized the industry and left others to catch up with its newly found competitive advantage.

From Exhibit 5 we see that human capital is at the core of creation of all other intangibles and thus must be the prime area of attention for effective management and oversight. From this effort other areas must also be supported through "sustainability of intangibles" metrics.

10.2 RELATIONSHIP CAPITAL DISCLOSURE

As a general measure trends in client satisfaction are important; however, so is the understanding of outcome. If, for example, an organization can assess the linkage between client satisfaction and re-purchase intentions, it can put a notional value on the "backlog" of potential purchases within the customer base. Such a measure might provide an effective base for creating an ROI from improving client satisfaction through product or process enhancements.

An alternative might be that depicted in Exhibit 6, which shows how client stratification, turnover levels, and profitability might be used as a barometer for a net present value calculation of the customer relationship "asset."

In Exhibit 6 an organization has established its profit contribution from each stratum of clients using activity-based costing (ABC) to ensure core costs are accurately reflected. The organization has identified that the baseline turnover rate (loss of clients) ranges from

EXHIBIT 6. FINANCIAL "PRESENT VALUE" OF RELATIONSHIP CAPITAL

Stratification of customer base	Profit Contribution	Years Amortized	Asset base value	Annual loss rate	Discount applied (3 years)	% value attributed	Amount Attributed
"A" type customers	$2,750,000	5	$13,750,000	5.0%	15.0%	85%	$11,687,500
"B" type customers	750,000	5	3,750,000	10.0%	30.0%	70%	2,625,000
"C" type customers	150,000	5	750,000	15.0%	45.0%	55%	412,500
Cash clients	350,000	5	1,750,000	20.0%	60.0%	40%	700,000
Total profit contribution	$4,000,000	5	$20,000,000			77.1%	$15,425,000
Less common costs	1,500,000	5	7,500,000			77.1%	5,784,375
Net earning capacity	$2,500,000	5	$12,500,000			77.1%	$9,640,625

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5% to 20% per year. It has determined that the value to be attributed will be based on five years of earnings, but that the equivalent of just three years of losses/turnover will be applied. Based on this, the base state valuation of the "business as usual" client base is $9.6 million. If client turnover rate increases, or client profitability levels decrease, and/or support costs change, then the overall value of the client base will change as well. The same approach might be applied to the assessment of a supply chain where an organization can assess the impact of the supply chain on overall cost of goods versus a competitive benchmark.

10.3 PROCESS DISCLOSURE METRICS

This category will have already been adopted by many organizations utilizing balanced scorecards. The scorecard's "process" dimension should begin to reveal the value of effective processes. Typical metrics that demonstrate increasing or declining process value are:

- Transaction cost/unit compared to history and best practice benchmarks of the process (e.g., volumes such as units/hour or cycle times, using ABC to accurately reflect process cost);
- Cost of poor quality by process (i.e., tracking of both defects from a quality management system as well as the financial impact of such failures);
- Percentage of transactions/cycles that meet best practice benchmarks; and
- Customer satisfaction levels with key process outcome capabilities (e.g., cycle times, accuracy rates, etc.).

This is a key area where the shift towards process- and activity-based thinking within organizations, combined with adoption of new costing approaches such as ABC (activity-based costing), will allow the effective financial manager to align financial data with operational effectiveness in a way that can be linked and aligned to an organization's capacity to execute and, through that, to its implicit goodwill/intangible value.

At the optimum level, managers and executives could develop metrics such as overall system capacity utilization as a measure of organization effectiveness using new tools such as throughput accounting. This approach would start to define the organization more effectively as a "system" and look at elimination of constraints as a way of assessing the optimization of an organization return on total assets through optimization of capacity utilization.

11 GLOBAL BEST PRACTICE EXAMPLES

Examples of best practices in various categories of reporting can be found on the World Intellectual Capital Initiative (WICI) website (http://www.worldici.com/) and the CERES-ACCA Sustainability Awards site (www.ceres.org). Examples from the former site related to "managing for value" include:

- Gap Inc., a designer, producer, and retailer of clothing and fashion. This example identifies Gap's competitive advantage relative to its people strategies and the importance of social responsibility in managing a supply chain in which much of the production takes place in less developed countries. This example reinforces the linkage between "reputation" and organizational activity. Gap was an early adopter of reporting against supplier performance relative to best practices following Nike's problems with child labor. Standards such as SA 8000 and the upcoming ISO 26000 are examples of emerging global approaches that support reporting such as that adopted by Gap Inc.

- Carmax Inc., a U.S.-based automobile retailer. This example shows managing for value, again with emphasis on financial and physical assets as well as customers and the supply chain (the relationships). This provides interesting insight into how the organization's people and process strategies provide a compelling competitive advantage that supports its customer relationships.

This site also includes financial services organizations such as Wachovia Corporation and Wells Fargo. PriceWaterhouseCoopers is also active in the field of leading-edge reporting through its review and assessment of supplemental corporate sustainability/CSR reports produced under the GRI (Global Reporting Initiative) framework and others (see www.corporatereporting.com/good-practice.html). While such reviews are not yet mandatory, this involvement demonstrates how the traditional role of financial oversight is being broadened and how the work of accounting professionals is changing.

12 PROGRESS ON DISCLOSURE WITHIN THE ACCOUNTING PROFESSION

As previously discussed, initial efforts by those in the field of intellectual capital and knowledge management began to devise approaches in the 1980s and early 1990s. In parallel to this work was the effort to improve corporate disclosure in areas such as environmental and social reporting, which are directly linked to the market's perception of an organization's conduct within its business environment. Notable in this area is the development of the SIGMA framework, which attempted to integrate all levels of organizational capital (natural capital, human capital, social capital, manufactured capital, and financial capital) into a reporting framework and the work of the Global Reporting Initiative (in developing triple bottom line disclosure of economic, environmental, and social performance. Additional approaches include the creation of L'observatiore de l'immateriel with founding members such as Ernst and Young, SAS and others).

Work has also been underway on a global basis to improve overall financial disclosure and reporting through activity such as the Enhanced Business Reporting Consortium (EBRC) initiative. Progress in recent years has become significant as the converging concerns of greater public disclosure and the importance of intangibles assets are colliding. An important organization operating in this area is WICI (World Intellectual Capital Initiative), which was promoted and formed by EBRC, European Federation of Financial Analysts Societies, Japanese Ministry of Economy, Trade and Industry, the Organization for Economic Cooperation and Development, Society for Knowledge Economics, University of Ferrara, and Waseda University. The organization's goal is to develop a global framework for improving the reporting of intellectual assets and capital and key performance indicators.

13. CONCLUSIONS

The role of intangible assets in an organization's performance is increasing. The basis upon which financial accounting standards are founded precludes many of these intangibles from being incorporated into traditional financial statements. Nevertheless, creating and nurturing intangibles is having an increasing impact on an organization's competitive advantage and through this its business ability to sustain its operation and remain viable.. As societal expectations of public corporations and entities change, reputations and thus the value of shareholder investments are increasingly impacted by behavior in areas such as social and environmental policy.

The accounting profession needs to be active in these discussions and to move the agenda forward for the following reasons:

- Those responsible for corporate governance and oversight need help in developing a greater understanding of the need to be more certain that the organization is sustaining those factors that are key to its ability to grow and prosper in the future. Board directors in particular need to be aware of the intangible drivers of competitive advantage and hold management accountable for continual growth of such capacity. There is good groundwork already in place using tools such as the balanced scorecard and activity-based costing; and these can be built upon.
- Management needs to be aware of how its day-to-day approaches to leadership and management are impacting the integrity and sustainability of its intangible assets, in particular the people and relationships that enable the organization's capacity to produce and serve. Financial reporting alone cannot fill this gap, yet this remains a key source of information for investors. Again, part of this capa-

bility is in place with areas such as relationship surveys, but more needs to be done. These items need to be developed within an overall accountability framework.

- Management accountants need to be active in developing an understanding of the size and importance of the "undisclosed" intangibles in their organizations and in starting to develop key performance indicators using, where practical, existing examples and frameworks. Through this, management accountants can enhance their value-added capacity by ensuring both protection of underlying assets and sustainability of capacity to execute as well as overall competitive advantage. At the moment much of the focus has been on rationalizing "fair value," especially when goodwill has been created from a buy/sell transaction, but a far greater focus needs to be given to assessing "predisposition" values of intangibles as well as ongoing assessment of intangible trends.
- Leaders in the accounting profession need to clarify the line between areas of accountability that remain within the scope and definitions of existing accounting standards, and then establish a solid and visible presence in the thinking relative to nonreported "value" that falls outside these definitions.
- Finally, accountants need to develop strong relationships with those who have specialized skills in this area to more actively engage them in discussion and to bring their more "economic" approaches into discussion. Such groups would include those engaged in business valuation activities and environmental performance management.

The financial community has a key role in reporting on the ability of an organization to function as a "going concern," and auditors' assessments of this capability are increasingly focusing on the performance of intangibles, yet companies' MD&A (management discussion and analysis) in its annual report remains the key window into these aspects of an organization's health.

The accounting profession is engaged on a global basis in seeking out ways to enhance and improve business reporting. Those involved in external reporting and compliance issues have a responsibility to expand their role and provide a greater level of assurance. Those reliant on financial reporting are already seeking greater insight through initiatives including socially responsible investing (in which due diligence extends to include social and environmental performance) and carbon green house gas disclosure reporting (through which investors are seeking to understand the organizational performance implications of publicly-traded companies on CO_2 emissions) as well as other non-renewable sources.

Those involved internally must be able to provide information to management that indicates the health of their organization's intangible assets and that illustrates whether these are being built or depleted as a result of management actions, policies, and procedures or due to external factors. Management must be in a position to report to those responsible for oversight that they are indeed both protecting *all* assets of the organization and also making effective use of the key intangibles, to drive competitive advantage. Direct financial implications will start to be seen when carbon trading is implemented and emission reporting has direct financial results.

The accounting profession is now starting to be involved in these questions and good progress is being made. Yet a broader involvement and engagement of professionals to seek out ways through which better and more valuable information can be provided to investors and management as well as to other interested parties is needed. The future of the profession depends upon its ability to be engaged in such initiatives; otherwise, it will become increasingly focused solely on items covered by accounting standards and thus become better and better at measuring and reporting what is less and less relevant to protection of wealth and optimization of competitive advantage.

14 GLOSSARY

Activity Based Costing (ABC) —A costing methodology that measures the cost and performance of cost objects, activities, and resources. Cost objects consume activities and activities consume resources. Resource costs are assigned to activities based on their use of those resources, and activity costs are reassigned to cost objects (outputs) based on the cost objects' proportional use of those activities. Activity-based costing incorporates causal relationships between cost objects and activities and between activities and resources.

Balanced Scorecard (BSC)—A performance management system that emphasizes the linking of an organization's performance metrics to its vision and strategy. By organizing metrics along financial, customer, internal process, and learning and growth perspectives, it provides a balanced view of organizational performance.

Committee of Sponsoring Organizations (COSO)—COSO was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private sector initiative that studied the causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions. Since that time, it has issued guidance on internal controls and enterprise risk management, enabling publicly traded corporations to deal with fraud, controls, risk, and compliance issues.

Corporate Social Responsibility (CSR)—A framework for the inclusion of public interest issues such as environmental, economic, and social issues within corporate decision making and accountability; first efforts on CSR started with Ben and Jerry's in 1987.

Emotional Intelligence (EI)—A term given to the ability to perceive, identify, and relate to oneself, others, and groups.

Enhance Business Reporting Consortium (EBRC)—An organization formed initially by the AICPA, Grant Thornton LLP, Microsoft Corporation, and PricewaterhouseCoopers LLP to investigate and suggest ways to structure and provide financial information to key stakeholders in a way that adds greater value.

Global Reporting Initiative (GRI)—An independent institution that began in 1997 and became independent in 2002. It offers sustainability reporting guidelines that help make the reports more standardized. It is an official collaborating center of the United Nations Environment Program..

Goodwill—1). An asset account that appears as the result of acquiring a business entity for an amount in excess of the fair market value of the identifiable net assets. 2)Characteristics of a business entity, not individually identifiable, that permits it to earn above normal returns on the identifiable assets.

Insights®—The trade name of a tool referred to as the "Insights Discover Profile" (as well as a range of additional tools) through which an individual can develop an understanding of self and of relationships with others as individuals and groups.

International Intangible Management Standards Institute (IIMSI)—An organization formed to assist companies in creating breakthrough performance improvements through enhanced analysis and reporting of value creation.

Intellectual Capital—Nonfinancial assets of an organization that create an organization's value and competitive capacity; typically represents the value not represented by financial assets.

Key Performance Indicators (KPI)—Typically defined as being those performance measures most relevant and critical for the monitoring and assessment of an organization's activity.

Knowledge—Expertise acquired by a person through experience and education; may also be used to represent the capacity of a collective such as a group of employees within an organization.

Knowledge Management—Organizational practices used to retain data in an orderly format and then to facilitate analysis of that data for business knowledge (e.g., recognition of trends). Extends to the distribution of useful insights throughout the enterprise.

Management Discussion and Analysis (MD&A)—Written part of a corporation's annual report, required by the U.S. Securities and Exchange Commission. In the MD&A, management comments on the firm's recent performance and the outlook for future performance. The information is used to supplement financial statement information.

Myers Briggs—A psychometric questionnaire designed to measure psychological preferences of how people perceive the world and make decisions; the test is based on the work of Carl Jung and was originally developed by Katharine Briggs and Isabel Myers.

ROIC—Return on Intellectual Capital; traditionally may also refer to return on invested capital.

SIGMA—The SIGMA project was launched in the U.K. in 1999 to develop a set of integrated guidelines for management to help them address the challenges posed by social, environmental, and economic dilemmas, threats, and opportunities.

Socially Responsible Investing (SRI)—In this context a technique utilized by investors to assess an organization's risk in terms of both financial and broader- based CSR risks and through this to engage in investments that maximize both financial return and social good.

Sustainability—Progress that meets the needs of the present generation without compromising the ability of future generations to meet their own needs, while preserving biodiversity and natural ecosystems.

WICI—World Intellectual Capital Initiative, a global public/private sector collaboration aimed at improving capital allocation through better corporate reporting information.

15 REFERENCES

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16 ADDITIONAL RESOURCES

WEBSITES

Brand Finance: www.brandfinance.com. Look for various publications, in particular the various "Intangible Trackers" and brand value reports.

Corporate Register: www.corporateregister.com.

EBRC (Enhanced Business Reporting Consortium): www.ebr360.org.

FASB (Financial Accounting Standards Board): www.fasb.org.

GRI (Global Reporting Initiative): www.globalreporting.org.

IASB (IAS) International Accounting Standards Board: www.iasb.org.

IIMSI (International Intangible Management Standards Institute): www.standardsinstitute.org.

Observatoire de l'Immateriel http://www.observatoire-immateriel.com

WICI (World Intellectual Capital Initiative): http://www.worldici.com