Perceived wisdom
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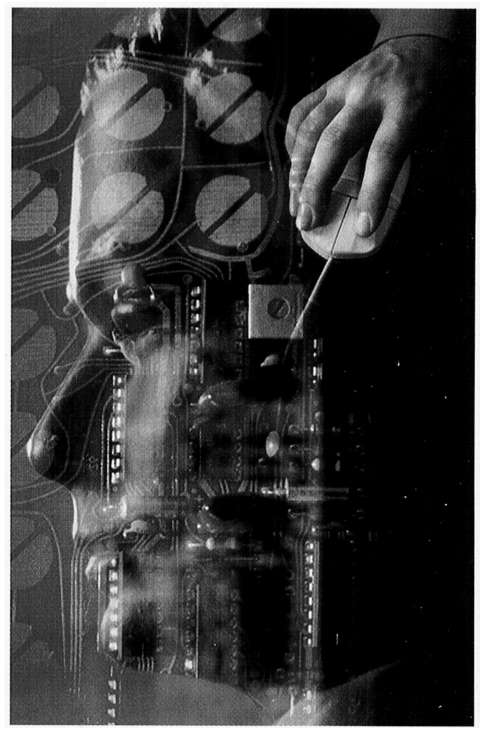

Bernard Marr, **Jan Mouritsen** and **Per Nikolaj Bukh** describe the main guidelines produced by Danish-based research into how to improve the effectiveness of intellectual capital reporting

One of the accepted clichés of recent years has been that knowledge and other intangibles are the engine of business performance. At the same time, though, intangibles are often wiped off the corporate agenda because they don't really fit into the management vocabulary of bottom-line performance.

These so-called soft assets really are today's hard assets. Firms achieve strong competitive positions by managing intangibles that are hard to replicate, while most tangible assets have become transient commodities. Only about 5 per cent of Microsoft's market value is explained by the assets that are reported on its balance sheet, for instance. Even for firms that are less knowledge-intensive, no more than about 30 per cent of their market value are reported in their financial statements.

A business's failure to report intellectual capital (IC) has the following implications:

- Smaller shareholders could be disadvantaged, because they usually have no access to the data on intangibles that's often shared with larger investors in private meetings.
- Insider trading could occur if managers were to exploit information on intangibles that's unknown to other investors.
- The firm could be valued incorrectly, which would lead investors and banks to place a higher risk level to the business, which would in turn increase its cost of capital.

Various initiatives are under way to tackle the shortcomings of intangible management and reporting – most notably, E*Know Net and Meritum, research projects funded by the European Commission. The two schemes are supported by about 60 companies in seven EU countries as well as by the Organisation for Economic Co-operation and Development and the European Investment Bank. The other large project is one sponsored by the Danish government to design guidelines for firms to prepare IC statements. The guidelines have been tested in around 100 firms and public organisations.

Although the guidelines vary slightly in content and terminology, the main ideas are the same. Organisations are encouraged to produce reports that contain three main elements: a knowledge narrative, management challenges and a set of indicators.

The knowledge narrative describes the strategic objective of the organisation, including its customer value proposition and resource position. Because it's a narrative, it must contain a storyline involving a chain of causes and effects. It conveys how the products and services of a business add value to its customers, and it identifies the critical knowledge resources that will help the organisation to deliver the value. By using words such as "because", "therefore", and "in order to", the organisation can describe how knowledge assets drive organisational performance and deliver value to its stakeholders. The knowledge narrative will therefore establish the link between value perceived by customers and the company's knowledge resources.

Translating the knowledge narrative into well-defined management challenges involves explaining which knowledge resources need to be strengthened or acquired in order to tackle the challenges and achieve the strategic objective. Management challenges are further broken down into activities, initiatives and processes that need to be put into place to address the challenges and attain competitiveness. In this part of the IC statement, organisations can clarify their resource allocation and prioritise activities and managerial actions.

In order to measure how well the organisational challenges are being managed, a firm must put indicators in place. These quantify the success of the actions corresponding to individual management challenges. Indicators make it possible for an organisation to visualise its performance in terms of its IC management. The firm must ensure that the set of indicators makes it possible to monitor whether the initiatives have been successful and the management challenges have been achieved. There is no pre-defined set of measures, so businesses will have to chose the most appropriate set for their particular situations. The set can include indicators that measure effects, activities or the resource mix.

We believe it's no longer optional for firms to improve how they report what really drives performance. Many European companies are already producing IC statements voluntarily. These will help to improve transparency, produce more accurate valuations and reduce volatility. At this stage, all firms should start producing such reports, because only experimentation will let us identify best practice. FM

The Meritum guidelines and those of the Danish research project on intellectual capital reporting can be downloaded from www.som.cranfield.ac.uk/som/cbp/meritum.htm and www.vtu.dk/icaccounts respectively.
Understanding Corporate Value: Managing and Reporting Intellectual Capital, an executive briefing published by CIMA in association with Cranfield School of Management, is available to download from the institute's website (www.cimaglobal.com/downloads/intellectualcapital.pdf).

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