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## **Intangible Assets, Tangible Risks** ***Options for Assessing Threats to Your Intellectual Capital***

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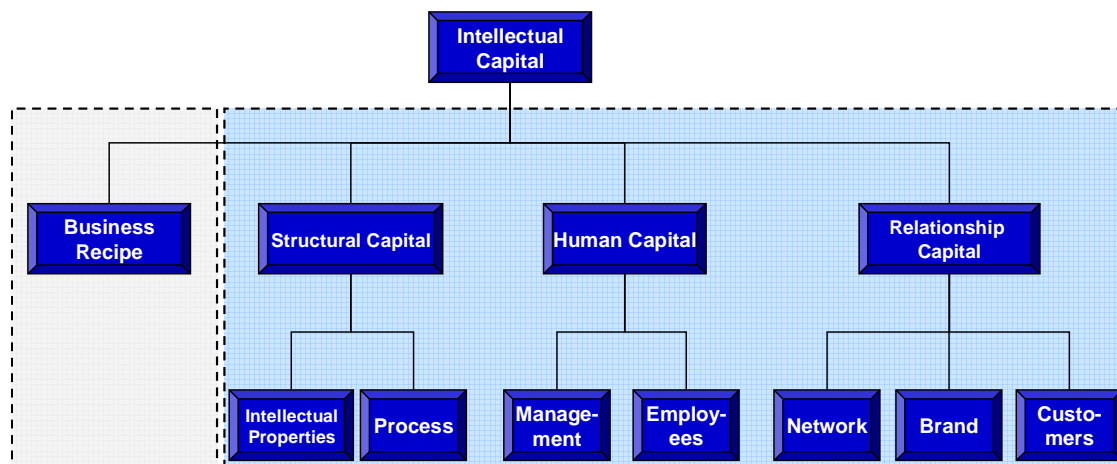
Service companies make money by leveraging the intangible. Your “products” cannot be seen or put in a box. Your processes are much less visible than those on a Ford production line. Your core productive assets are not on your balance sheet. In fact, many of your most important assets walk out the door every night. Yet these intangibles are the key to your company’s growth, innovation, and competitive advantage.

The portfolio of intangible assets of a corporation is referred to as its “intellectual capital” (“IC”). Intellectual capital includes a broad range of people, knowledge and relationship assets. Understanding the current strength and future outlook of this portfolio is a key strategic challenge for the management team of a service company. Risk assessment plays an important role in the strategic management of intellectual capital. How can you best assess IC risk? Read on for a discussion of your options.

### **The Importance of Intellectual Capital**

The easiest and most graphic way to understand the importance of intellectual capital to service businesses is to look at stock market values of public companies. Today, the book value of the S&P 500 averages less than 20% of their market value. For some service companies, their tangible book value represents less than 5% of their corporate value. The remainder comes from a market premium and intellectual capital.

The phrase “intellectual capital” is frequently used as a synonym for knowledge. While knowledge is a critical part of IC, it is much more, as seen in the following graphic:



## Where Are the Risks in Intellectual Capital?

Like all corporate assets, IC is vulnerable to catastrophic risks due to weather, crime or accidents. These risks are already on the radar of most companies. What you may not be watching are some of the specific risks associated with the different components of the IC portfolio. The following summary looks at each of the four major components:

**Structural Capital** includes the huge range of knowledge that resides within your organization. At one end of the spectrum is the formally recorded, legally protected knowledge in patents and trademarks. Next is the knowledge included in software and formal process. Then, there is all the other knowledge residing in manuals, instructions, intranets and other written resources. At the other end of the spectrum is the shared knowledge that is manifested in how people do what they do—but may not be written down.

*The key risks associated with structural capital include the:*

- *Inadequate documentation and dispersion of knowledge*
- *Weak and/or inconsistent work processes*
- *Inadequate protection of proprietary knowledge*

It is pretty common to focus on defenses against loss of intellectual property. However, with structural capital, the best defense is actually a good offense. What do I mean by that? The best way to protect your ideas is to implement them consistently across the firm, provide good training and consistent quality control. The better your execution, the harder it is to imitate your ideas.

**Human Capital** includes all the people that work in your organization. The skills and experience of your people are critical. Hopefully, you have a set of core competencies that are shared throughout your organization. There are also specific management skills that you want to have and nurture. However, the most important long term role of human capital is to originate and perfect new knowledge that can create future earnings.

*The key risks associated with human capital include the:*

- *Probability of and vulnerability to key management and staff turnover*
- *Inadequacy of skills levels and/or inconsistent dissemination across the firm*
- *Failure to create a culture that accepts change and values learning*

The impending retirement of the Baby Boomer generation is a serious risk to the human capital of many companies. In a service businesses, the loss of informal knowledge and experience that is not (and in many cases cannot) be formally recorded, represents an especially big risk.

**Relationship Capital** is in many ways the most important component because it represents your connection with the marketplace. Customers pay the bills in every

business. The strength of your customer relationships and your brand will determine your current and future potential to generate business. IC also looks at your external networks of vendors, outsourced services, and complementary partners as a critical resource for the firm.

*The key risks associated with relational capital include the:*

- *Probability and vulnerability to customer or partner defections*
- *Relationship loyalty to individuals, not the corporation*
- *Threats to the brand*

The growth in outsourcing of all kinds (from accounting to IT to labor) makes external relationships more important than ever. We have seen many cases recently where the core of both customer and outsourcing relationships is overly dependent on a single person or very limited group. Although strong personal relationships enhance your corporate relationship, there needs to be a balance so that a loss of a single person does not translate into a significant business loss overall.

**Business Recipe** is your firm's strategy. The right strategy is an asset. This includes staking out the right market and having the right approach to that market. Business recipe is also the critical touchstone for evaluating IC and answering the question, "Do we have the right IC to deliver on our strategy?"

*The key risks associated with business recipes include the:*

- *Threat of new competitors*
- *Potential of substitutes*
- *Exposure to economic cycles*

Examining your business recipe risk forces you to look at the interdependencies of the IC portfolio. No one component of IC creates value—value is created by matching resources together. A good example of the benefit of looking at IC as a portfolio comes from an event company we know that has a strong staff skilled with strong core competencies associated with its existing business. However, the organization is facing competitive threats and is in the process of launching new offerings that involve elements of training and consulting. The product launch team was relying on existing staff to man this new business but an evaluation showed that the staff's skills in the new areas were weak. The firm no longer has the right IC to deliver on its business strategy. It was only through a portfolio examination, looking at people, knowledge and relationships together, that this risk became clear.

## **Options for Identifying IC Risks**

There are basically three ways to evaluate the risk of a corporate intellectual capital portfolio.

**Rely on functional departments** – Most businesses today see the risk of individual IC components to be the province of functional departments such as human resources, marketing, sales, operations, knowledge and corporate management. This approach benefits from the deep knowledge of each function—who better understands the specific risks facing the company in that specific area? However, a divided approach lacks the overall perspective that comes from seeing IC as a portfolio.

**Perform a corporate-wide self-assessment** – A company-wide IC assessment can be performed by focusing on the full portfolio and examining the specific risks of each category using factors such as those discussed in the previous section. This approach guarantees a broad perspective to better understand the complex interaction between the business recipe, knowledge, people and relationships that make up IC. However, as with any self-assessment, there is a risk of skewed results due to lack of perspective and vested interests.

**Use a third-party assessment** – Many consulting firms have developed intellectual capital assessments that support corporate management teams efforts in the field of corporate value enhancement, innovation and change management. Some tools, such as IC Rating™, include a specific risk rating for the IC. A third party tool ensures objectivity and often provides comparability due to the use of a consistent methodology.

In a service business, your core asset is intellectual capital. Although it is intangible, the risks to IC are all too real and tangible. Protect your company from these risks by understanding IC and the unique risks that can threaten it. Identify, measure and put in place risk management plans for the specific risks faced by your company.

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