Out of the Twilight Zone

Options for Assessing Tangible Risks of Intangible Assets

By Mary Adams

Managing a business today can be like living through an episode of the *Twilight Zone*. We live in the knowledge economy that was sparked by the rise of computing and the internet. But most of the basic management tools used every day in every business across our economy were optimized for the factory-led economy of the past. Much has changed and much will still change. But we all need to update our skills and tools to catch up.

Until then, the *Twilight Zone* moments multiply. Today, financial statements can only account for about 20% of the value of the average company (versus 83% in 1975). Accountants and business people consider the rest of the company to be “intangible,” indescribable and fleeting in value. This information gap rolls through many of the other tools in the average manager’s kit. What is this mysterious 80% of corporate value? How do you get yourself and your organization out of this *Twilight Zone*? And how do you manage risk in this environment?

What Are These Intangibles?

The “intangibles” dominating business today are actually knowledge assets of one form or another. They are created through investment by organizations in their people, their computer systems, processes, data, intellectual property, networks and business models. These knowledge “assets” together make up the intangible capital (IC) of an organization. IC assets work together as a system, a machine or a factory—and are the key drivers of how companies generate revenue today.

Think about Federal Express. FedEx owns lots of planes and trucks and electronic gear. But that’s not what’s important to the company’s ability to run its business. The company’s key asset is the end-to-end process that can move packages from one place to another as efficiently as possible and keep everyone along the way informed of where each package is at any moment in time. This process is a knowledge asset that needs data, software, knowledgeable workers and effective partners to work.

The FedEx example shows why it is necessary to break down the intangible capital of a company into key categories:

- Human Capital: the competencies, experience and knowledge of people
- Structural Capital: the knowledge captured in the form of databases, processes, documents, IT systems and intellectual property (patents, trademarks, trade secrets and copyrights)
- Relationship Capital: the shared knowledge and understanding of networks of people or groups
- Strategic Capital: how the prior three kinds of capital are combined to solve a problem for a customer or a stakeholder

Seeing knowledge this way—as discrete, identifiable (albeit interrelated) assets makes it much easier to set up management and measurement systems to get intangibles out in the open. And it's a great foundation for risk analysis.

Where Are the Risks in Intangible 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:

Human Capital includes all the people that work in your organization. The skills and experience of your people are critical. Knowledge and learning begin and end with people. Employees keep everything going every day. And they originate and perfect new knowledge that can create future earnings. The key with human capital is to turn smart people into a team who want to share their knowledge and institutionalize best practices so the team isn't at risk when any one individual walks out the door at night.

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 one example of the serious risks associated with human capital of many companies. The loss of informal knowledge and experience that is not (and in many cases cannot) be formally recorded, represents an especially big risk for every company.

Structural Capital includes the huge range of knowledge that stays in your organization when everyone goes home at night (as such, it's one of the answers to human capital risk of knowledge walking out the door). Structural capital can take many forms. At one end of the spectrum is the formally recorded, legally protected knowledge in intellectual property (IP). Next is the knowledge included in software and formal process. Farther along, there is all the other knowledge residing in manuals, instructions, intranets and other written resources. Finally, at the other end of the spectrum from IP is the shared knowledge that is manifested in work patterns and culture which are shared and understood in the organization—but not necessarily written down.

The key risks associated with structural capital include the:

- *Risks associated with the information technology on which most structural capital is built.*
- *Inadequate documentation and dispersion of knowledge*
- *Weak and/or inconsistent work processes*
- *Inadequate protection of proprietary knowledge*

The two most common areas of focus with structural capital risk are around IT and IP (information technology and intellectual property). Most strategies are defensive: what can we do to protect our IT and IP from harm? 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 knowledge and systems.

Relationship Capital is not always immediately understood as a knowledge asset. But the growing interconnections facilitated by technology with customers, outsourcing partners, suppliers and many other kinds of partners have created a body of *shared* knowledge that is critical to the operation of most businesses. Shared is a key word here because, while sharing is an important component of relationship capital, it also represents a source of risk to the organization. Many an American company has given away its IP in recent years as its knowledge has moved from the category of proprietary structural capital to the category of shared relationship capital with outsourcing partners.

There is another aspect to relationship capital that is embodied in brand and reputation. Reputation gets more and more attention because of the vulnerability created by social media and always-on communication systems; any mistake can be broadcast immediately and the price for it can become significant. In many ways, reputation has become the most important metric for business today; it's your license to do business in the future. As important as profits are to a business, no one cares how much BP made before the oil spill. What counts is the confidence of their stakeholders going forward. While reputation can and should be managed through a marketing function, the real work comes from strategic and risk management of the entire organization's intangible capital.

The key risks associated with relationship capital include the:

- *Probability and vulnerability to customer or partner defections*
- *Data and knowledge shared with customers and partners*
- *Relationship loyalty to individuals, not the corporation*
- *Threats to the reputation*

Strategic Capital is the knowledge of your market, your business opportunity and the business model you create to take advantage of that opportunity. The right strategy is an asset. This includes staking out the right market and having the right approach to that market. Strategy 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 strategic capital include the:

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

Examining your strategic capital risks forces you to look at the business implications of the IC portfolio. No one component of IC creates value—value is created by matching resources together.

To Understand Risk, First Understand Your IC

Let's return to the FedEx example. If you want to understand the intangible risks to FedEx where would you start? The smart thing to do is to create an inventory and a model of the key intangible components of their business. Here's a sequence that helps drive the thinking:

- Start with the business model. How does the company create value for customers? What are its sources of revenue? (strategic capital)
- What are the processes that support this model? (structural capital)
- What are the knowledge and/or data sources necessary to support this model? (also structural capital)
- What are the core competencies of the organization's people that are critical to the success of this model? (human capital)
- Who are the customers and partners needed to make the model work? (relationship capital)
- What kind of reputation is necessary for the model to succeed? (also relationship capital)

If you answer these questions about FedEx—or your own business—you have the right framework to analyze its intangible capital. There are unique risks for each element of this system or "knowledge factory." You probably are already aware of many of these individual risks. But what are you missing? Creating a top-down inventory or model of your intangible capital ensures that you don't miss anything. It also gives you a framework for understanding how all these different elements—and risks—are interconnected.

Options for Identifying IC Risks

Once you have a good "picture": of the knowledge intangibles of your business, there are basically three ways to evaluate the risk of a corporate intangible 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 intangible capital assessments that support corporate management teams efforts in the field of corporate value enhancement, innovation and change management. Some tools, such as IC Value Drivers™, tap into the wisdom of a broad range of stakeholders to assess the strengths and risks of the full IC portfolio.

When analyzing risk, get out of the Twilight Zone. Start paying attention to the 80% of your business value that's intangible. There is no going back to the industrial era. The knowledge economy is here to stay. The effect of this change will continue to be felt in every business in every corner of the globe. To remain competitive as a professional and as a company, you will need to master the basics of the management of knowledge assets, the intangible capital that dominates your organization's ability to create value, drive revenue and maximize performance and innovation—today and in the future.

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