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OPERATIONS MANAGEMENT

Will CFOs Keep Their Seat at the Strategy Table?

By Mary Adams

The financial statements produced by CPAs have been the gold standard for objective, consolidated information about the health and outlook of a business. But with the rise of the knowledge economy, this standard is losing its sheen. CPAs face greater challenges in trying to account for many of the knowledge resources that are driving competitive advantage in a "flat" world; many of these resources being intangible assets. As the value of intangible assets eclipses that of tangible assets, there is a growing information gap at the corporate strategy table. Companies need information about intangible resources to make the best decisions in this new era. Will CFOs have the knowledge to close this information gap to keep their seat at the table?

The shift to intangibles has happened pretty quickly. One of the simplest ways of illustrating the shift to a knowledge economy is to look at the stock markets. Thirty years ago, there was a strong correlation between a company's stock price and the book value of its assets. Today, only 20% of the stock price of S&P 500 companies can be explained via their balance sheet book value. Most people don't think about the implications of this discrepancy because it has been so long since we had a useful balance sheet; we may even forget what it's supposed to tell us.

Ever since merchants in 15th century Venice started using financial statements, their purpose was to keep score on past operations. Balance sheets have been used to detail the resources with which a company will build its future. If you were a merchant, your balance sheet showed what you had in inventory and what you paid for it, so it also gave a great view into your potential earnings for the coming year. If you were a manufacturer, your balance sheet also showed your investment in plant and equipment; this again was a good indicator of your future potential.

What Are Intangible Assets?

Today, balance sheets cannot give this type of view of a company's potential because the most critical resources in the knowledge economy don't qualify for accounting treatment. These intangible resources can be classified as:

- *Human Capital*. People, employees and managers.
- *Structural Capital*. Knowledge, including intellectual property, know-how, processes, systems and software.
- *Relationship Capital*. Brands and external relationships with customers as well as partners, such as suppliers, distributors and manufacturers.

These intellectual capital resources drive innovation, earnings, growth and competitive advantage across every sector of our economy. Today, even with an industrial company like GE, intellectual capital is more important (GE's book value is around 30% of its stock price).

Information about these intangible assets is scattered across most companies. For example, the human resources function tracks personnel, and the marketing and sales areas own information about the customers. However, none of these items appears in a consolidated report. Can you imagine a merchant without an inventory report, having to sell product and not knowing the quantity or price of goods the business has? Yet, this is the position that corporate leaders are in today. They lack basic consolidated information to answer the most important questions about the corporation's future:

- *Do we have the right people, knowledge, technology and network to meet our goals?*
- *Are we positioned for continued innovation?*
- *Where are we at risk?*

Boards of directors, investors and analysts are all in the same boat. At best, they gather anecdotal information from various sources and use their intuition to derive conclusions about the state of the company's core value drivers. Few ask the CFO; moreover, few CFO's are prepared with the answers.

If the balance sheet is losing its value, where does this leave the "keeper" of the balance sheet? Without a meaningful balance sheet, the CFO will continue to account for past earnings, rather than contributing to strategic decisions about building the capacity for future earnings.

There are those in business and academia working to develop new information paradigms, including many in the accounting profession. It will be many years before definitive standards are developed. Most companies cannot afford to wait. They will be driven by strategic and competitive concerns to gain a better perspective on their portfolio of intangible resources. Will you be prepared to support this effort? Or will your seat at the strategy table go to a new player who is better prepared to provide the information critical to the future of your company?

How CFOs Can Keep Their Seat at the Strategy Table

A CFO's role at the strategy table will depend on whether they are considered the keeper of the traditional accounting or as the source of objective, consolidated information about the organizational resources. To expand their role, they will need new skills and new tools to augment their knowledge of financial accounting. But they will need to learn about other ways of assessing resources and performance. As a CFO, your advantage will be that you are trained as an objective professional who sees the corporation as a system. You can use those skills to bring a consolidated perspective on your company's future.

There are many in the accounting field looking at this challenge. Last year, the Fed started to measure intangible aspects of the GNP on a trial basis. Most in the field recognize that there are many aspects of intangibles that will never be measured through traditional accounting. The AICPA a couple of years ago, through the New Paradigm Initiative, asserted that there really needed to be two parallel measurement systems: 1) the traditional financial transaction-centric approach; and 2) new value and performance measurement systems. Links to this initiative, as well as many other resources on this subject, are available at the Intellectual Capital Knowledge Center at www.icknowledgecenter.com.

Having the Right Mindset

Do not think that this is all theoretical and far in the future. There is a lot that you can do today. It all starts with some new tools and approaches—but not so different from the approach you take today. Let's look at it the way that Luca Pacioli, the "father" of modern accounting, laid it out 500 years ago.

Pacioli said that you should start out with an inventory. After this, what are the resources that have on hand with which to build the future of your company? You can start with tangible assets but also include intangibles, such as brands, employee skills, processes, software, customer lists, and external networks. In the case of many of these intellectual capital resources, you probably can't put a dollar value on them but you can assess them, which is actually more powerful strategically. Are you weak or strong? Are you investing in the future? Where are you at risk? You can do this yourself or use a third-party tool such as IC Rating™.

As Pacioli advised, you need to monitor transactions and performance over time. Here you cannot rely on financial transactions alone. Rather, you want to focus on leading indicators â€" or as many people refer to them as key performance indicators or KPI's that will lead to financial transactions. What has to happen for your earnings to rise? Where do you need to focus your efforts? How will you know that you are on the right track? Build a trial tracking system and keep learning and adjusting—there is no one set of the "right" metrics for a business.

These approaches may make you uncomfortable at first. They are not based on financial transactions with third parties; they are aimed at getting objective assessments of corporate health. Isn't that ultimately the mandate of the CFO? Shouldn't you add to your skills set to complete the picture of your organization's health? It will earn you a continuing place at the strategic decision making table. It will also give your company the leg up it needs to win in today's competitive global economy.

About the Author

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