

# Why Intangibles Matter

**F**inancial results are important but are often lagging indicators of performance. Intangibles, on the other hand, showcase the firm's ability to play the game and win in the future. Here's how board directors can set up a process to monitor and measure what really matters.

By Patricia Seemann and Norm Smallwood

Most discussions today that address management and governance issues seem to revolve around malfeasance, ethics and the desire to legislate honesty. A thesis on the importance of corporate intangibles may seem analogous to a dissertation on hydrodynamic design conducted while the



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ship is sinking due to a hole punched in its hull. The majority of CEOs, whom one may never hear or read about, take care in following crucial and sound financial practices and adhering to legal guidelines and responsibilities. However, what is so often easily forgotten is the need to take care of the corporate intangibles so easily taken for granted.

If it were possible to simply legislate compliant behavior, children would not take drugs, inner-city crime would not exist and Enron's reputation would be intact. The truth is that decency and integrity arise not from laws but from social norms, values and standards. In the business world, this translates into the underlying culture of the firm, the way its employees are treated and the types of behavior that are rewarded. In today's business environment, it is essential that corporate intangibles are managed and governed every bit as rigorously and deliberately as tangibles.

## Why Are Intangibles Important?

First of all, what is an “intangible”? *The Economist* offers an amusing definition: “An intangible is anything in a firm that generates value that you can't drop on your foot.” This would include a company's people, brand, reputation, relationship to customers, decision-making process and ability to innovate, as well as investor confidence in the company's strategy and ability to deliver upon it.

It could be argued that intangibles are the most significant growth driver in the US economy. More than 60 percent of the aggregate value of the stock market is based on future expectations, with 30–60 percent of an average company's value lying in its intangibles. In addition, wild swings in a company's stock price are more often than not investment community reaction to intangible issues, such as an unexpected innovational success, the departure or entrée of a key figure, or a reputation crisis. Nevertheless, present governance and management practices focus almost entirely on the tangible assets of the firm.

For example, at a typical pharmaceutical company, 80 percent of the present market valuation is based not on current value but on *future* expectations of value. Of the remaining 20 percent, only about 2 percent is based on current earnings. But where do management and the board put their energy? Toward budgets, planning, controlling and auditing—all of which deal with that mere 2 percent. How much attention and systematic work is put towards intangibles, the other 98 percent of the firm's value?

Senior executives realize that there is a serious contradiction here. According to a recent Accenture survey, 96 percent of executives consider intangibles important; in fact, 50 percent place them among the firm's top three issues. But 95 percent also admit that they have no formal process to measure and improve intangibles.

This is not to say that intangibles are not managed at *all*—most firms have HR departments and communications groups, for example—but rarely are they managed in an integrated way. Instead, the departments exist as independent silos, between which form the cracks and contradictions that can eventually cause a breakdown in governance and management.

## Signs of Intangible Health

A firm is successfully managing its intangibles\* if it:

1. Has a track record of keeping its promises
2. Has a compelling strategy that stakeholders understand and have confidence in
3. Invests in building technical capabilities in line with this strategy
4. Focuses on building the organizational capabilities that enable it to deliver its strategy

\*Adapted from: *Why the Bottom Line Isn't*, Ulrich and Smallwood, Wiley 2003.

## What Steps Should a CEO Take to Manage Intangibles?

### Step One: Measure

The first step toward managing intangibles is to measure them. The CEO must have a clear understanding of the firm's key intangibles and the factors that influence his or her performance. These key intangibles vary from firm to firm; some companies need to focus on talent, others on branding, etc. In addition to providing a guideline for the CEO, the measurement of tangibles at the senior-most level of an organization provides an incentive for management and employees to pay attention to them.

One way to measure intangibles is to conduct an “intangibles audit,” evaluating stakeholders’ perceptions of the four signs of intangible health cited above. By identifying those intangibles that matter to the various stakeholder groups and discovering the gaps of contradiction among them, an intangibles audit can deliver meaningful and relevant results within as little as four weeks.

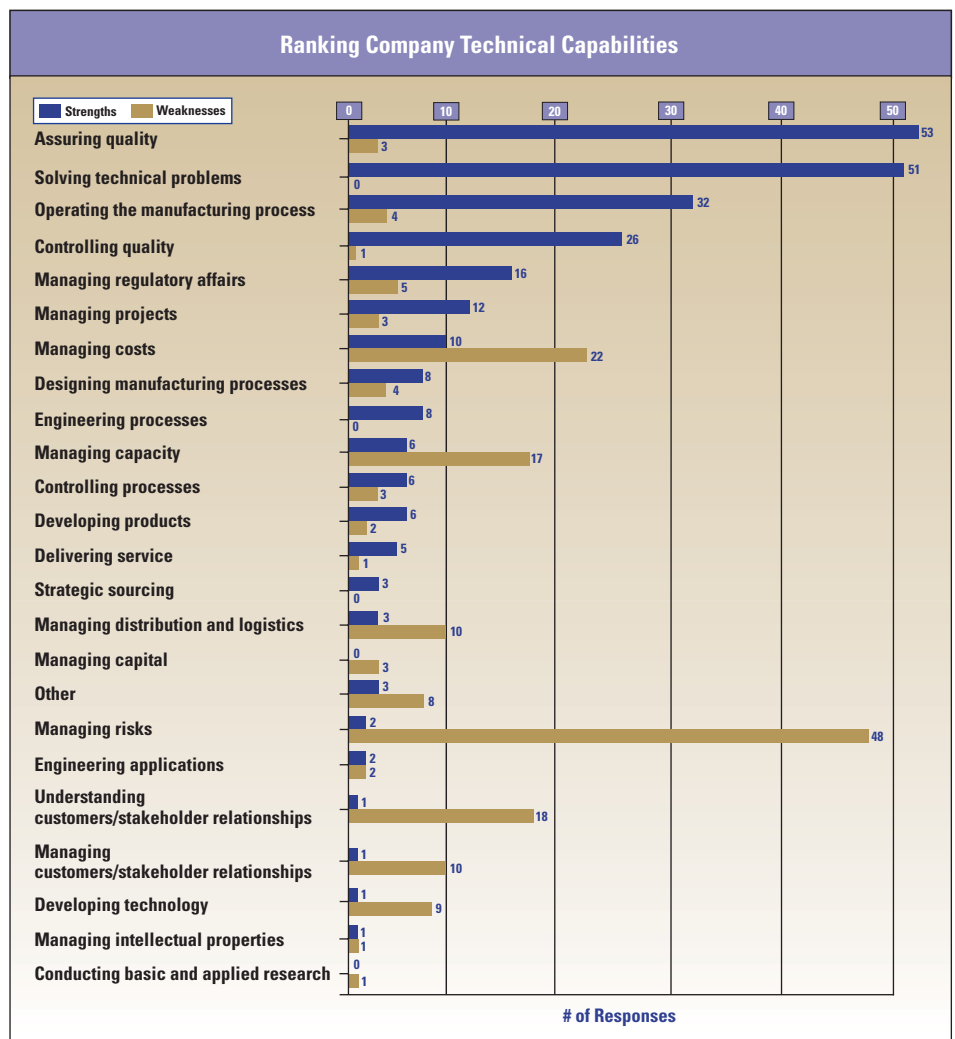
For example, Intercontinental Hotels was going through a difficult period a few years ago. Like most companies in similar situations, the company reduced costs. Although this pleased the analysts, the CEO had a sense that the cost-cutting had gone as far as reasonably possible and justifiable. By performing an intangibles audit, the company discovered that its customers were clamoring for improvements in services and facilities—in other words, investments in Intercontinental’s brand. The CEO used this data to convince stakeholders to support aggressive investments in growth rather than continuing to focus on cost reductions. Within a year, Intercontinental’s stock value increased by nearly 60 percent.

A global consumer products company participated in a company-wide intangibles audit asking employees, senior executives, middle managers and supervisors to provide their perceptions about each level of intangibles—keeping promises, compelling strategy, aligned investments and organization capabilities. The results of the audit showed that internal stakeholders believed that they kept promises and generally understood the growth strategy. However, important gaps were identified in their technical and social capabilities:

### Technical Capabilities (Level 3)

Several insights were revealed when participants were asked to rank the company’s top three technical capability strengths and weaknesses from a common list. The dominant strengths emerged as 1) assuring quality 2) solving technical problems, and 3) operating the manufacturing process. Managing risks was identified by over half of all participants as a key technical capability weakness. This response validates the theme of risk aversion that had been highlighted by earlier action teams exploring decision making, culture and leader behavior.

The fourth level of this audit, organization capabilities, explores the recognized social capability strengths and weaknesses of the firm as well as the systems and leadership behaviors that reinforce those capabilities. Audit responses to organization



Source: Sphere Advisors

capabilities were the most varied of all levels. Collaboration, quality of leadership and talent were three specific items with strong responses. The remaining organization capability audit items scored in the neutral range, with the exception of “measuring organizational effectiveness at the behavioral level,” which was reported as the lowest item in the entire audit. The executives at the consumer goods company who sponsored this audit found the feedback extremely helpful in pinpointing where and with whom they should take focused action.

### Step Two: Organize

If a CEO is serious about exerting power and influence for taking control of his/her firm’s intangibles, there are three important tasks that must never be delegated. These are:

1. Setting the direction of the firm
2. Determining the appropriate style of leadership
3. Managing the reputation of the firm

Interestingly, virtually every intangible crucial to an organization’s value can be organized under these three headings. For this reason, it is crucial that intangibles themselves are assigned only to those employees who can be relied upon to project the CEO’s vision, style and will into the firm unadulterated.

### Step Three: Establish an advisory board

Because intangibles are so crucial to a CEO’s success, power and survival, the threat of closed-loop thinking and executive-level betrayal is very real. As such, outside input can be extremely valuable. One way to garner this objective, third-party input is to establish an advisory board composed of world-class experts with expertise and knowledge pertaining to the core intangibles of the firm.

To fit into the context of a CEO’s world, an advisory board should include fellow CEOs or those professionals experienced in working closely with chief executives for many years. In addition,

its membership should represent a broad range of intangibles expertise. For instance, if a CEO has determined that the firm's main issue is branding, the advisory board should include not only brand experts, but also professionals who understand how branding decisions are likely to influence the culture, media perception and target audience of the firm (not to mention the views of regulators and reactions of NGOs).

### What Steps Should a Board of Directors Take to Manage Intangibles?

#### Step One: Add intangibles to charter and agenda

The general perception is that a board of directors is only interested in supervising the numbers and ensuring strict adherence to legal requirements. As trite as it may sound, the most important thing that a board can do is decide that corporate intangibles do matter. Making intangibles part of the charter and working agenda declares to all stakeholders that the board recognizes the underlying, reputation and value disciplines reflected throughout the organization. If awarded the appropriate time and attention, managing intangibles effectively instills board confidence that the values, norms and behaviors prevalent in the firm will reliably ensure first-rate governance practice.

#### Step Two: Include members with interest/experience in intangibles

Given corporate governance issues, companies are finding it difficult to secure individuals willing to serve on corporate boards, particularly publicly traded companies. Moreover, given recent corporate scandals and aggressive legislative attention, most companies now find themselves looking to recruit individuals with the same kind of expertise: financial. While financial expertise is crucial, it does not represent all required aspects. Intangibles require informed judgment born from a mixture of knowledge and experience across various non-financial disciplines. The subtler message is that this focus on the financial leads to board members who generally possess similar mental models and decision-making algorithms. This suggests that board decision-making will focus on narrowly defined issues, going over the same pathway again and again, deepening ruts and never leading to a new pathway of thinking. Intangibles logic suggests that this is not a good recipe for success.

## What Boards and Executives Don't Know About Their Business

According to a new survey of 249 executives worldwide conducted on behalf of Deloitte Touche Tohmatsu by the Economist Intelligence Unit (EIU), only about one-third (34 percent) of board members and top executives polled say their companies are proficient at monitoring critical non-financial indicators of corporate performance. The majority of board directors and senior executives surveyed for the study said that factors such as customer satisfaction, innovation, supplier relations and employee commitment are critical to corporate success. But they admitted that there were difficulties in monitoring these drivers of organizational performance. By contrast, the study indicates that 86 percent of executives believe their companies are excellent or good at measuring and tracking the performance indicators necessary for financial reporting purposes.

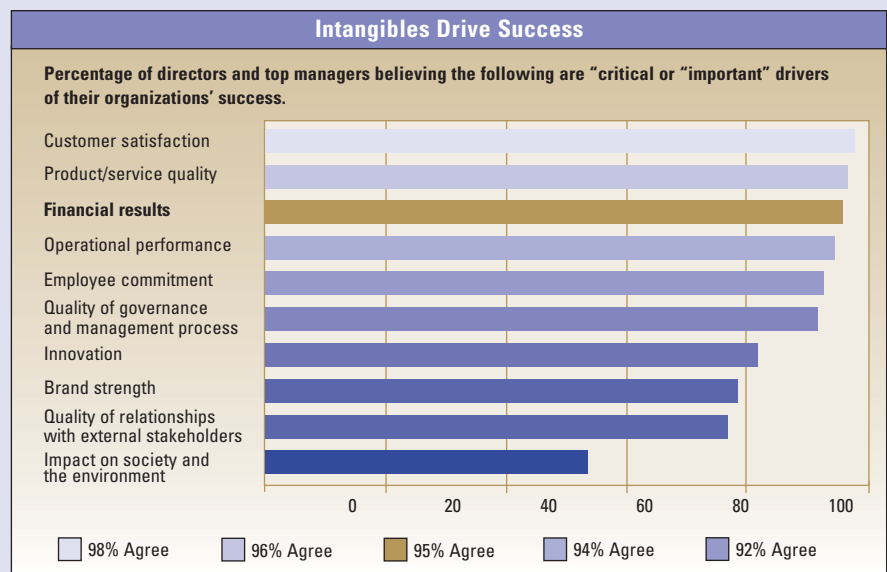
"The findings are a warning sign that unethical behavior by a small number of executives is not the only critical issue in corporate governance," says William G. Parrett, Global CEO of Deloitte. "It takes more than tracking financial performance to properly mind the store. And most board members and executives acknowledge that the tools and systems to monitor non-financial performance are either underdeveloped or are missing altogether."

The survey found that most board directors and executives need more non-financial information on how well their companies are satisfying customers, delivering high-quality products and services, operating with efficient processes, and developing new products and services. Almost 75 percent said their companies were under increasing pressure to monitor non-financial performance indicators. And 92 percent said their board directors were responsible for monitoring both the financial and non-financial measures of their companies' performance.

The survey revealed that the minority or only a slight majority of the companies said their board directors are given excellent or good information in key areas, including:

- The company's impact on society and the environment (27%)
- Employee commitment (35%)
- Relations with suppliers and other external "stakeholders" (39%)
- Product/service innovation (43%)
- Customer satisfaction (50%)
- Brand strength (51%)
- Product/service quality (52%)
- The quality of corporate governance and management processes (56%)

Asked why board members and senior managers lacked information on the many of the vital signs of their businesses, respondents identified two barriers more frequently [or "as more important"?] than any others: the absence of developed tools for analyzing non-financial measures, and skepticism that such measures directly impact the bottom line.



Source: Deloitte Touche Tohmatsu, Economist Intelligence Unit

### **Step Three:**

#### **Set up an operations committee**

Corporate tangibles represented on the corporate balance sheet or quarterly earnings reports are lag indicators of performance — a firm's "scorecard," so to speak. Intangibles, on the other hand, showcase the firm's ability to play the game and win in the future. As such, it is unconscionable for a board of directors to establish an operations committee for tangibles while ignoring the intangible aspects that play such an important role in the ongoing life, sustained reputation and longer-term shareholder value of the organization.

#### **How Should a CEO and Board of Directors Work Together to Manage Intangibles?**

##### **Make meetings matter**

Traditionally, meetings at the executive and board levels are highly polished PowerPoint-fests with every word rehearsed and tightly choreographed to ensure that no warts or fissures are visible. Too often in these meetings, dissent and difficult questions feel improper and out of place. Such performances and gestures benefit no one.

Discussions in such settings should instead be intellectual "free-for-alls," wherein information and opinions are shared in terms of historical context and future opportunities. Dissent should be encouraged as interpretations of data and alternative responses are discussed and reviewed. Less time should be spent reviewing data and more time spent debating and proposing alternatives.

The objective of a board meeting is not to display good manners and sociability; the goal should be to develop an action plan that the firm can follow to create and maintain lasting value. The management team and the board are the supreme decision makers of the firm, so disagreement should not be seen as disrespect but rather as a potentially important presentation of a relevant point of view. Hiding the organization's warts and fissures is as misleading and counterproductive as prettying up the numbers.

##### **Trust each other**

In the area of intangibles, which are so closely related to the CEO's persona and so critical to the wellbeing of the firm, yet so ambiguous, a trusting relationship between the board and CEO is absolutely critical.

Many boards place too much emphasis on policing their CEO, rather than helping him. If the CEO interprets the action of the board as being s focused on "finding him out," second-guessing his decisions and perhaps even trying to trip him up, then he/she is likely to be resentful, less forthcoming and more likely to withhold both tangible and intangible information.

Similarly, the CEO must treat the board with respect as a precious source of advice and guidance. To provide valued counsel, the board must possess a rich and broad understanding of the firm's key intangibles and be privy to the CEO's decisions regarding them.

Intangibles are equally important as financial performance. The firm must be able to demonstrate a track record of keeping promises, a compelling strategy, investments in line with that strategy and rigorous development of the requisite organization capabilities. To achieve this goal, the CEO must ensure that intangibles are measured and monitored, and organize himself and his environment in such a way that the key intangibles are managed in an integrated fashion. Similarly, the board must make intangibles part of their charter and working agenda, as well as seriously considering the creation of an operations committee. Most important, the CEO and board of directors must accept and welcome dissent, work together to find common ground and trust each other with the issues that are important to the company's future success. ■

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