The New Longitude Perspective for Value Creation

Leif Edvinsson and Mart Kivikas

Prof. Leif Edvinsson is the world’s first holder of Professorship of Intellectual Capital, at the University of Lund, Sweden, the first Director of Intellectual Capital at Skandia, Sweden, and was appointed Brain of the Year 1998.

Why we use in our financial world still almost the same bookkeeping methods as they were when they were invented 500 years ago? Today the highest growth potential for a company or a society lies outside its classical balance sheet or its physical boundaries. It lies in its Intellectual Capital (IC). As one of the pioneers in the world of IC the authors present their new perspectives and experiences of how an organisation can start to cultivate and develop its full potential of IC for economical growth. A special reference is made to how you can assess the potential by rating the IC in order to visualize its benefits and to put it on the decision-makers agenda.

1. Why Corporate Longitude?

Much of the leadership perspective today is lacking the perspectives of Intellectual Capital – IC. A more elaborated distinction of IC is future earnings capabilities or in other words is about derived insights about main value creation and sustainability.

The traditional economical maps that we can find in many key institutions and offices are like old maps in museums. It highlights industrial areas, farming areas, housing etc. How much can such a map help us to understand the knowledge economy, intellectual capital and intangible assets? And who will take the responsibility to reshape the new economical map in the age of institutional failure for a deeper collective understanding of wealth creation of today? Where is value created in New Zealand?

In our days the old economical mapping system called accounting is cracking, like the navigation map did 300 years ago for the British Navy. Just look at two of the largest corporations in USA, Enron and Worldcom that collapsed, like ships in the fog. It is said to be the largest liquidation of assets in corporate history. The lessons for managing intangibles might be as profound and long lasting, as the solution of the longitude problem 300 years ago. Almost 70% of the financial analysts, according to a research from Senator Joe Lieberman, who investigated Enron, were still recommending purchase of the stock when the US Securities and Exchange Commission had started to investigate the case.

Not only the analyst but also the accountants and auditors are being hanged out now for the failure of navigation. Uncertainty and confidence for our economical value navigation is now diffusing, with implications for future wealth creation, not only on corporate level, but also on society level. Just look at the despair of the global economy for the moment of December 2002.

The collapse of Enron and Worldcom highlights the shortcomings of the old accounting system as well as accountability based management for the modern society or the innovative organization. It points towards serious problems of reporting and assessing both society and corporate potential of intangibles. The analysts and investors have to guess on intangibles due to lack of insightful intelligence. This approach is often referred to as senti-
ments instead of fundaments, with increased volatility and risk of the stock exchange. This collapse of Enron and Worldcom is therefore shaking not only a big accounting firm like former Andersen, but also the whole economical value mapping profession and its trustworthiness. It is undermining the trust of the mapping system for the value creating institutions and organizations.

In a historical perspective this mapping and measurement situation has similarities to the above mentioned longitude problem in navigation 300 years ago. The British Navy was then able to navigate with precision only in north-south directions, not east-west, i.e. the longitude. This is very similar to the dilemma for the financial analyst and accountant of today. The precision in management is mostly in the vertical balance sheet perspectives of cost accounting and tangible assets dimensions. The future earnings values lies in the intangible values such as key persons, networks and relationships, alliances, culture, knowledge recipes reside in the lateral perspective versus the balance sheet, i.e. the longitude dimension.

Until sailors could measure longitude, they were frequently lost at sea. The same is the case for our value generating leadership of today. The difference between knowledge economics and tangible product based economics demands a similar shift in the way we view the Corporation and track its value creating progress. We have to take a lateral perspective regarding alliances, networks, cultural context, knowledge recipes and other intangibles, usually outside the balance sheet perspective.

Below is an illustration of Corporate Longitude as a lateral dimension of intangibles inside and outside the firm’s vertical balance sheet. What is needed is an intelligence window for those new spaces of value creation.

2. Intellectual Capital as the New Wealth of Nations

Only knowledge will give us the opportunity to create a better wealth of nations. So we need to develop the new map of knowledge assets and the intellectual capital (IC) of nations. A map of regional IC, instead of the old agricultural and industrial map of societies, often found in regional planning offices. The key-mapping dimension should be around the quest for; where is wealth created in our region/country and who is mastering this IC? And even more insightful: What is the meaning making or essence of this enterprising? Further more there is a huge social opportunity cost of not leveraging our brain potential now, but rather leaving it idle, or as an asset in waiting. And the value of not leveraged IC cannot be stored as value of raw material mines.

According to the OECD report Scoreboard 2001 – Towards a Knowledge – based Economy the countries with knowledge intensive activities will be the winners of future wealth. In this report the 30 member countries are scored according to IC investments such as R&D, education, patents, ICT etc. If summarised as by Financial Times/DI in Sweden, the top list of potenzials to future wealth will look like this:

1 – Switzerland
2 – Sweden
3 – USA
4 – Ireland
5 – Netherlands

In 1996 Caroline Stenfelt-Dunn and some student colleagues from the University of Stockholm together with Edvinsson investigated as a prototype how his work at Skandia on IC could be translated to a national stage. The first report on IC of Nations was born, labelled as Welfare and Security. In 2002, Nick Bonitis, McMaster University, Canada, did one of the most interesting researches in the area. Based on the model from Skandia he and his colleagues, in a study sponsored by United Nations Development Program, made an investigation of 10 Arab States. In this study he quantified the state of IC for the nations and launched an IC Index.

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for Nations that can be used for ranking as well as benchmark learning between nations.

In the research case from Nick Bontis can be concluded that the following ingredients, in the stated order, are key areas for the political agenda to shape IC of Nations

1. National agenda for Renewal, Research and Development, i.e. Innovation Capital
2. National agenda for Education, i.e. Human Capital upgrading and leveraging
3. National agenda for Foreign Trade, i.e. Relationship Capital and Knowledge flows
4. National agenda for Productivity, i.e. Process Capital with special focus on cultural context

By mapping the IC components of a society, an agenda to shape the infrastructure and structural capital for future wealth can be derived. This might be an illustration of how the public sector governance in a knowledge society has to focus on the interaction space between structural capital of society and the human citizen capital to reach a higher collective yield of prosperity. In other words an IC multiplier effect.

3. The New Corporate Longitude

Most attention is still devoted to the financial map, in a world of corporations where the tangible assets account for often from 0.1 % to 25% of a company’s market value. For these assets the organization has a CFO and controllers, software systems called ERP and the whole profession of auditors. But what resources does an organization have for the nurture and development of intangibles and intellectual capital? Mainly a CRM (customer relationship management) system? In 1991 Skandia appointed Edvinsson as the world’s first director of IC to develop another logic for the renewal of the company. This work resulted in, among others, a refined taxonomy, measurements and accounting systems for IC as well as innovation systems for IC, such as Skandia Future Centre (see www.skandiafuturecenter.com). However, it is still too rare as a function for organizational value creation.

The financial reporting and its position on the global news agenda have become an obsession, which furthermore is becoming more and more illogical. What we now need is much more intelligence about the intangibles and where value is created. For example, if you are investing in your competence upgrading, is that a loss or something of value? In the old accounting practice it is regarded as a loss. It is the same way with research and development (R&D). Is that a loss or a potential future? This is resulting in anorectic leadership behaviour, trying to starve the organizations into the future, especially by savings on the important nourishment of intangibles, such as knowledge, R&D and learning.

The value is created in the interaction between people as human capital and the organizational structural capital such as R&D processes. The 500-year-old accounting system is focused on historical costs and transactions reporting. This backward looking metrics approach leads to growing inaccuracies in the value-creating map of today. Furthermore, it results in misallocation of resources by investment institutions. It is like asking what is the cost of good or bad weather, instead of asking for the weather forecast. What is needed is a longitudinal system to visualize, cultivate and capitalize on these value creation interactions. We have to go from cash measurement by cash registers, to a time based measurement by chronometers of innovation and networking speed.

The old model of business must also be challenged. Most of the real value of knowledge falls outside the range of traditional management vision. The theory of the firm needs to be replaced with the theory of community. Full time traditional employment contracts will be replaced by more part time based alternatives, such as now is elaborated in Denmark by its employers association. The source of added value for businesses and societies in the knowledge economy comes from enabling opportunity, and building flexibility and innovative responses to a fluctuating market space. If harnessing potential and mutating towards the future? are the driving winds powering that journey, we need mechanisms beyond monetary reporting to keep track of speed and direction. What measurement systems can support this sea change in orientation? Certainly the contribution from the essential associated intangibles such as trust and collaboration are well beyond the scope of conventional accounting systems. The value of relationships needs to be measured, as does the contribution from knowledge recipes.

4. IC Measurement

Why is measurement so important? Simply because lack of communicable information affects trust as well as the efficient supply and distribution of future resources. What is needed in a growing complexity is a clarifying supportive system to sensitise our minds to perceive the best options, by the new potential interactive combinations, rather than old repetitive best practice approach. Communicating these intangible interactions is crucial to attract the right resources for wealth creation.

As the new economical value is in the longitude, i.e. lateral dimensions instead of vertical dimensions, we have to develop more lateral accounting of value creation potential of intangibles. We have to acknowledge such new indicators, get the accountants to audit those, and annual reports to present transparency of such intellectual capital, to be able to navigate these new organizational value creations. IC-Rating™ is one tool, complimentary to the Standard & Poor’s rating of financial capital. IC-Rating™ is about benchmarking the perspectives of efficiency,
renewal and risks on IC components, for future earnings potential (see www.intellectualcapital.se). It is now used by more than 200 organizations both in Europe and Japan. It seems to be especially interesting for public organizations such as schools and hospitals. This approach is now also being applied for regional rating of IC of cities and regions.

In one German company, the value scheme of Intellectual Capital is used to make an IC-Rating™ in order to measure output of one of its service departments. Such use of IC-Rating™ as a tool to evaluate and measure output instead of input (budget) is a logical evolution in an organization that has adapted the potential and importance of IC (see www.wissenskapital.info).

5. Spaces for Value Creation

For the German speaking market we have been prototyping a ‘Wissenskapital-Matrix’. It is based on KPI’s (Key Performance Indicators) for 5 dimensions – Value Added, Competitive Advantage, Sustainability, Future Potential and Conformity.

The “Wissenskapital-Matrix” shows the potential a company has if it starts to use parameters to measure that are not only found in the existing accounting system, but more adapted towards future earnings and future transactions. It does not say that all investment in IC has a prosperous future, but it puts the right issues on the agenda and it supports management to pick out the right investments – important especially today. Once it is used, it should be seen as an integral part when evaluating new projects and investments.

On the basis of an ongoing research project with the EU called PRISM, in which Edvinsson participates, some modelling is emerging about the value chain of the new theory of the firm. This modelling is highlighting the value creating areas of the enterprising as well as the key focus area for leadership. It is especially to be used to highlighting what we call capital in waiting.

6. Longitudinal Management in the Knowledge Economy

Clark Eustace bases the four arrows on taxonomy from an earlier EU project lead under the name of HLEG (European High Level Expert Group) on IC. They are laid out horizontally to represent the fact that such assets or capital can be accessed from both within and from outside the firm’s traditional legal boundaries.

To the left of the “value creation mixer” lie the tangible and intangibles assets over which ownership rights can – more or less – be appropriated. Tangible goods would include physical assets such as land and buildings, and plant, machinery and equipment. Intangible goods would include assets such as software, brands, trademarks, licenses, and rights over scientific discoveries.

To the right of the “value creation mixer” lie the intangible competencies and latent idle capabilities or, in other words, capital in waiting. Intangible competencies embrace the organiz-
tional capital and the human capital, which effectively, is leased for productive use from the individual knowledge workers. Latent capabilities are what investors, in particular venture capitalists, are interested in; their discovery and exploitation is where top leadership truly differentiates itself from others.

At the center lies the “value creation mixer” where leadership faces the challenge of leveraging these longitudinal resources and create economic value. It might lead to growth of capital on the balance sheet as well as impairment of the balance sheet and then value destruction will occur. What is the leadership of today doing to avoid erosion and leverage the idle capital in waiting and how do we know from the reporting?

In terms of measurement, the traditional reporting model mostly represents the tangible goods sector and has begun to encroach on segment 2, based on emerging requirements from among others IAS – International Accounting Standards Board. However, it is not yet able to represent the full potential of the networked intangible business model of the 21st century based on intellectual capital. In large part it is restricted by the concept of ownership and confined to reporting on elements it can identify within a firm’s legal boundaries. This is inadequate in the knowledge economy.

The leading edge of new guidelines for the assessment of IC is today to be found in several prototyping forms done in Scandinavia. In December 2002 the Norwegian Association of Financial Analysts as well as the Danish Ministry of Science launched their new guidelines for IC-reporting (see www.videnskabsministeriet.dk/videnregnskaber and “A Guideline for Intellectual Capital Statements”). This very early longitude thinking might assist us in getting out of the vacuum of lack of leadership in the present fog of economics. It might help us to see the need for much more focus on developing the organizational capital as multiplier for the human capital and its inherent potential for future earnings capabilities.

On the corporate level we face a new theory of the firm, sometimes referred to as “blown to bits” or the new theory of the un-firm. The map of knowledge logistics or flow might give birth to new value adding clusters of knowledge communities beyond the traditional corporate borders. A theory of the Networked Units is emerging. They are characterised by high interdependencies with high fluidity of knowledge, instead of traditional trade theory, based on chaordic knowledge management approaches, such as the conceptual basis for the establishment of VISA by Dee W. Hock. The new value is in the networked constellations, connection, synapses and contactivity. In short, the value space is in the intelligence and in the relationships. Consequently we need to develop a new set of contractual relationships for insourcing brains! A new role as society entrepreneurship (see www.wissenskraft.info) is needed for clarifying and shaping those organisational bridges and alliances for a higher wealth contribution from the brainpower potential of global citizens.

Literature

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