6 Ombuds: Measuring Intangible Assets 1992

Paul O'Malley

File together with
early
O cost-effectiveness
articles

PAUL O'MALLEY ASSOCIATES

11/5/92

To: Professor Mary Rowe

From: Paul O'Malley

Date: 1 November, 1992

Subject: **Ombuds Programs; Measuring Intangible Assets**

Thank you for the information you sent on Ombuds Programs. I am forwarding it to both the VP of Human Resources at Baxter and the outside director who has been fulfilling some of the functions of an ombudsman for that company. Thanks also for the information you related in our phone conversation last week. I relayed your thoughts to Vern Loucks, the Chairman/CEO of Baxter, and I believe that he is seriously considering the adoption of an 800 number.

I was very interested to hear that some organizations have contacted you recently, asking how they might measure the effectiveness of their anti-harassment programs. I see this question as part of a larger issue: how can organizations measure (and manage) a host of critical variables that I would classify as "Intangible Assets."

In the information economy that is maturing in the developed world, physical assets (such as Plant, Property and Equipment) play an increasingly smaller role in the processes through which firms add value. Reputation, customer relationships, capacity for absorbing change, employee morale---these things are intuitively understood by (forward thinking) management as being critical to business success, but none of them is explicitly measured and reported in the internal or external accounts of public companies.

I am enclosing some notes I have thrown together on this topic. It is my intention, ultimately, to devise a set of intangible asset accounts, with which an organization could track the flows in and out of key items on an Intangible Assets balance sheet. I would also like to develop a causal model (probably using system dynamics) that would attempt to map the linkages between the management of intangible assets (empowerment, team effectiveness) in the present, and profitability in the future. I would be very interested in your thoughts.

Thanks again,

Paul

23 Dale Street Newtonville, MA 02160 (617) 527-7653

Some Thoughts on Intangible Asset Accounting

Earnings have been described as a good leading indicator of future cash flows. However, I suspect that the great majority of future cash and earnings predictions are based on adaptive expectations: the past is projected into the future, and/or recent trends are projected into the future, perhaps adjusted by some fudge factor. The tendency to fall back on adaptive expectations is widespread; it is present even in the projections of the major econometric modelers (DRI, Wharton).

Adaptive expectations, or using current earnings figures and recent earnings trends to predict future earnings and future cash flows works best when a company's growth rate (and/or the growth rate of the economy) is stable. This approach works least well when those variables are changing--but that is precisely when a good predictive tool is most useful!

Predicting future cash flows and future earnings based on current earnings is also most problematic when the competitive environment is changing, or when the firm's relative competence within its industry is changing (for example, better or worse management).

More generally, I would expect earnings to be a relatively poor predictor of future cash flows in the face of discontinuities (for the reasons that econometric forecasts are generally pretty good except when the economy changes directions).

My hypothesis is that intangible assets, such as customer satisfaction, firm reputation, employee training levels and morale, brand image, R&D effectiveness, product quality, etc., are better leading indicators of future cash flows than earnings. In a causal sense, earnings can be thought of as a lagging indicator of these critical intangible variables.

What would we have seen had we been monitoring customer attitudes towards GM and Toyota products from 1976 through 1981? Would we have seen the lines cross before earnings told us there were problems at GM? What would measures of training levels and morale have told us? How far in advance of earnings?

Intangibles have not been measured in the past because they are difficult to measure. But by not measuring them, we effectively assign them a value of 0. Even a flawed attempt at measurement would be better than that.

Kaplan has pointed out that intangible assets are increasingly the **most important** assets of corporations.
For example, in a software firm, many of the critical assets go home at night.

There is a business to be created establishing metrics for intangible assets and doing independent audits of them for corporations. Perhaps a fourth item should be included in financial statements, along with the balance sheet, income statement and cash flow statement: an accounting of intangible assets.

Many of these variables could be measured statistically. Many of them are included in the Baldrige Award specifications.

Could the basic hypothesis be tested by going back and looking at GM's earnings, and comparing them to JD Power surveys, or Consumer Reports data on repair frequency, customer satisfaction etc.?

Case of Compaq computer (erosion of perceived relative value, due to maturation of the product lifecycle, that was not reflected in earnings until the bottom fell out).

Breakdown of Intangibles by functional area

I. Marketing
   A. Value positioning of firm and product in mind of customer "Perceived Relative Value"
   B. Relationship with various channels
   C. Quality of support infrastructure serving the channels
   D. Accuracy and timeliness with which organization understands customer requirements
   E. Level of customer satisfaction
   F. Reputation with customers and channels
   G. Nature and strength of brand image; relevance to various products or businesses (I.E., perils of line extension, diversification)

II. Product development
   A. Quality and efficiency of R&D
   B. Creativity of R&D staff
   C. Cycle time from conception (or identification of customer requirement) to market
   D. Level of expertise in critical technologies (pluses and minuses of outsourcing)
   E. Internal communication and dispute resolution mechanisms (engineering/marketing/manufacturing/finance)
   F. Process based vs. functional structure.
   G. What percent of revenue is generated by products introduced within 1, 2, 3, 4 & 5 years? How does that compare with the best in the industry (benchmarking)? Percentile of all these measures wrt the industry.

III. Human Resource Management
   A. What kind of people do we hire
      1. Intelligence
      2. Attitude
      3. Education level
      4. Group skills
   B. Employee morale
   C. Respect for Management
      1. Do peer and supervisor review
   D. Stress level (burnout)
   E. Employee training and education level

F. Employees' conception of opportunity within the firm

G. Turnover rates

H. Data from exit interviewing

I. Employee understanding of mission and vision wrt their jobs

IV. Operations

A. Level of quality

B. Rate of continuous improvement

C. Involvement of customers in process improvement

D. Integration with other functional areas within the firm

V. Senior Management/Leadership

A. What are employee attitudes towards management

1. Respect?

2. Trust?

3. Integrative/distributive?

B. How clearly has management articulated a meaningful vision?

1. Internally

2. Externally

C. How credible is management with financial markets?

1. Cost of capital (for a merger for example)

D. Perception of middle managers as to how to get ahead

1. Emperor's clothes vs. honesty and performance

E. Use some of Kotter's criteria for leadership

VI. Information Technology

A. Strategic use of IT

B. Effective Operational use of IT

C. Flexibility of IT infrastructure to take advantage of new technologies (client server vs. mainframe)

D. Flexibility of IT infrastructure to take advantage of business opportunities: does IT lead or hold you back?

E. "Corporate Software"

1. How effective is the IT infrastructure at capturing and interpreting the data stream?

VII. Corporate

A. Structure Itself as intangible asset

B. Everyone as CEO