THE GROWING IMPORTANCE OF INTANGIBLE ASSETS IN THE STOCK MARKETS.

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In a previous aticle[1] we have analyzed briefly how the internal logic of the knowledge economy differs from the industrial capitalist economy. We have acknowledged that this economy is really "post capitalist" and post industrial. We have also seen that most economic actors are still in an industrial mentality and try to manage a post industrial economy with industrial tools. This is perfectly understandable because there is not enough information and valuable debate on this shift between the industrial economy and the post industrial knowledge economy.

And this is perhaps the reason why the intelligent and prestigious "Lisbon strategy" of the EU is not working so well. This EU Lisbon strategy has been set up in March 2000 at the EU (Heads of State) Council meeting in Lisbon. It has decided to aim at making the EU the most competitive economic actor in the Knowledge society before 2010, but in a socially inclusive and sustainable way.

Now, in analysing how this Lisbon strategy is working, one observes that the strategies are probably too "industrial" to be really successfull. Once again it is perfectly understandable, because the EU and its prominent economists, have not enough explained to the citizens and the business actors the post indsutrial economic transformation we are in.

But it is sad to see a waste of money and energy, in the execution of such a good project.

Double standard

Let us listen one of the most advanced visionaries of the US business in the XXIst century, Susan Mehrtens[2]: « *American business, today wears two different faces. One is the face of the large multi-national, publicly traded corporations. They manifest an intense, single-minded focus on the bottom line, and are prepared to sacrifice almost everything to the quest for constant quarterly profits, to satisfy the Wall Street stock analysts. These companies practice an ethics of expedience (what works is right) and encourage extremely addictive behaviours among their personnel, most notably in the form of work*

[1] In this same magazine in the September October 2006 Number page 107-110.

[2] Susan MEHRTENS : « *Learning designs and the Third Wave* » in *Perspectives on Business and Global change*, a publication of the World Business Academy, Volume 13, number 4, December 1999, p. 59, Sales : Berret and Koehler Publishers, Email bkpub@bkpub.com

Mrs Mehrtens is know in USA through her excellent book on tomorrow's business, with MAYNARD Herman Bryant Jr: *The Fourth wave: Business in the XXIst century* Berret & Koelher, San Francisco 1996.

alcoholism…Not surprisingly we are seeing more and more people leaving this dysfunctional environment .

The other face of the US business is much more viable in terms of the future. It is the world of the small, privately held company… It is not *subject to the dictates of the stock analysts of Wall Street… Many of those small companies are owned or operated by women, or are informed by feminine values. It is these companies – small, nimble, fortunate by virtue of their marginal status – that will find smooth sailing on the waves of the future* [3]*».*

This double standard seems to be an accurate vision of the situation of the business today, in US, in the EU and elsewhere. One one side you have many enterprises in a classical traditional (industrial) logic. They are under market and short-term revenues pressure and are not treating humans in a very positive way. They seem to go backwards. And one the other side, you have those often women-owned small enterprises who care a maximum for the human dimension. They “will find a smooth sailing on the waves of the future”. This second vision corresponds to the witness of Rinaldo Brutoco, president of the World Business Academy. The management of Men’s wear, in which he is involved, is of the second type, and doing very well.

Those "new" enterprises have understood the new logic. In the knowledge society, and in this paradigm shift towards transmodernity, respect for humans is not only important, not only ethical; it is essential for the very survival of the enterprise. For a simple reason: knowledge becomes every day more important. And only creative humans can create new knowledge in inventing new knowledge through creative exchange of the knowledge they have. This creativity is like a flower that will blossom only if it is treated well, very well. This means much more that a decent salary. It means that the enterprise must have an excellent human capital management, but also a positive social and environmental impact on society. It means also that creativity will stop if there is any fear of sanction in case of mistake. Creativity supposes the possibility to make mistakes!

Lack of theory.

However those enterprises of the second type, who are very promising, lack a theory. They are in fact switching to a post industrial paradigm. But they are like in an intellectual void. Here is what Verna Allee, a worldwide

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consultant in knowledge networks management is stating[4]: *"Today we do believe that people are our core asset, that the way we use our knowledge and intelligence is the key strategic advantage of the company, that ethical principles do create value, that a company's culture is key to success. Yet we are bound by the golden handcuffs of business, financial and economic models and frameworks that continually pull us in very different directions. …Virtually all of our business and economic models, as well as our day-to-day management tools, are leftovers from the industrial age. Time and again I watch managers and executives try to move forward into new ways of working and managing only to be frustrated by tools and frameworks that are inadequate for the new economy."*

She warns the reader that the knowledge or intangibles economy is forcing us to a radical change: *"It is rewriting the rules of business and forcing a radical rethinking of corporate value and business models. This change is the most significant shift since the industrial revolution."*

Intangible assets : three dimensions.

Now there is a good news. We have got one piece of the new vision: the so called "intangible assets".

In 1986, a swedish scientist called Karl Erik Sveiby, wrote the first book worldwide on "intangible assets" in Swedish language. This book had a little succes in Sweden but it became famous when it has been translated in english and spread in US and in the whole world. It has laid down the first stone of the post industrial knowledge economy. For many people already active in the knowledge economy, it was the beginning of the new theory they were looking for.

Sveiby has since the beginning proposed to distinguish three types of intangible assets:

1. the human competence of the personnel that he called *human capital*. The people's implicit knowledge and how this implicit knowledge is made explicit[5] and shared inside the company.the internal structures of the company, which cold be called the *structural capital:* its internal tructures

[4]Verna ALLEE : *« New tools for the new economy »* in *Perspectives on Business and Global change*, a publication of the World Business Academy, Volume 13, number 4, December 1999, p. 59. Sales : Berret and Koehler Publishers, email: bkpub@bkpub.com. See also her excellent book: *The future of Knowledge: Increasing Prosperity through Value networks"* Butterwoth Heinemann, Elsevier Science, USA, 2003. Verna is also working in Europe as an expert for some EU research projects.

[5] This concept of implicit knowledge will be developped much more by Ikujiro NONAKA & Hirotaka TAKEUCHI "*The knowledge creating company"* Oxford University Press, 1995.

and management, its ICT technology and the way it is used and improved by the personnel, its patents, its databases, etc

2. the external structures and relations of the company, which could be called the *external capital:* its alliances, in which networks it is actively involved, networks of suppliers, of consumers and of citizens. Let us not forget also the trust that the people have in the company. (Are the people trusting more "Tupolev" or "Airbus", for example). And finally the reputation, the "Brand" of the company. We will see in this article that brand and reputation become everyday more and more important.

Now authors like Verna Allee, underline that the model is not static. There is like a *knwoledge flow* between those three categories of intangible assets. She gives in her book this interesting quotation*: "a company increases and utilizes its intangible assets by creating, sharing and leveraging knowledge to create economic value and enhance economic performance*[6].

Knowledge is created by sharing. And one could say that knowledge is like love, the more you share the more you have. This is quite shocking for "classical" ears of an "industrial" economist. But the value creation process, in the knowledge economy is quite different from the value creation process we are acustomed to in the industrial production. Indeed industry produces objects, and is adding value to an object: from a block of steel I make a Renault. I have added value to this block of steel.

But is the knowledge economy, there is no object. Just knowledge. And the value creation process consists in adding knowledge to knowledge. My personnel is paid to add value to knowledge.

Let us take an example. My friend created a small company for setting up websites and providing webmasters. This small company won the bid to run the website of the European Commission in Brussels and Luxemburg. The contract stipulates that every official text siisued by the EU Commission has to be on the web into 48 Hours translated in all official languages. The personnel *create value* in translating the given knowledge. They add knowledge to knowledge. No objects. By the way the management is completely different. Indedd the CEO is incapable to *control and command*. He is not fluent in all EU languages. So he has used networks to make sure that quality is the best. How? Let us take the example of the greek language. He organizes receptions putting in network all the greek language people in Brussels: Greek Commissionner and greeks in the Commission, Greek MEP's (Members of European Parlament), Greek in the Council of Ministers, Greek Ambassador, newspeople (radio, television, written press), Trade Unions, Consumers, intellectuals, etc. They all have a stake in having the best possible greek texts to work on. And the CEO, after a glass of champagne asks them to let the team know whatever error or problem could

[6] Verna ALLEE: *The future of knowledge..."* Page 158.

occur. Control is outsourced to an external network. Is this not a completely new type of management?

Ethics (values and purpose) is back in the picture

Finally Verna Alle shows that a company's values and purpose are the primary organizing principle determining who its customers are; and what type of people are attracted to work there; and what type of structures and systems are required. As Verna explains well, the leading force in this new game are the company's "values and purpose", while in the industrial world the main leading force is linked to the amount of profit made. We are touching here a very important difference.

And this means also that most of the intangible assets, because they are value and purpose based, are *qualitiative* and not quantitative anymore.

Finally ethics and values are thus coming back full speed in the picture, while most of the "industrial and scientific" approach was considered "value free" and out of the realm of ethics, because they were considered as "objective".

We are indeed in another world.

Intangibles are Future oriented: hence their importance for stock markets.

Let us now add another dimension to this intangible assets concept. They are "*future oriented"*. In another definition given by Baruch Lev in a book[7] on intangibles prepared by the Brooking Institution, in Washington, this new future dimension is underlined: *"An intangible asset is a claim to future benefit that does not have a physical or financial embodiment. A patent, a brand, and a unique organizational structure…I use the terms intangibles, knowledge assets, and intellectual capital interchangeably."*

This definition gives us a very important new element: future benefit. And suddenly we discover that the "industrial" measurements of a company, which are based on tangible assets, like financial and other material assets, are oriented towards the past. We are so accustomed to this appraoch that we do not even acknowledge that those tangible assets are giving us information of the company's performance from yesterday until today. You can measure if the the company has done well or not, according to the assets it has accumulated until today. But this accumulation of tangible assets does not give any information on how the comapny will perform in the future.

[7] Baruch LEV: "*Intangibles: Management, measurement, and reporting*". Brooking Institution Press, Washington D.C. 2001. Pp. 150. Quote is from pages 6 - 7.

Meanwhile, and this is the new element, intangible assets are concentrating just into those other elements, which are crucial for the company's future. One understands here immediately why intangible assets are so important today for the stock markets analysts and the Banking and finance community.

Accounting is dead: the problem is urgent for the banking community.

According to Thomas Stewart, editor of the "Harvard Business Review" and known author on intellectual capital[8], we are in a deep silent crisis, because we are still unable to measure correctly those intangible assets. This is a real threat to our accounting system worldwide: "*Accounting, long dead, is not yet burried, and the situation stinks. Okay, that overstates the case, but not a lot. In the past several years, the indadequacies of industrial-age accounting have been proved again and again. Both financial accounting, which appears in annual reports, and management accounting, the data that lands on your desk, go wrong in specific ways, and with demostrable consequences....(268)*

And what is wrong? The industrial-age accounting system seems incapable to take into account intellectual capital and intangible assets: "*Accounting's failure to disclose intellectual capital is not just a thoretical problem. It costs investors money – perhaps you dear reader, among them... We are not talking fraud, except in a few cases – we are talking irrelevance, with the result that investors are kept in the dark and managers are operating by gues and by gosh." (272).*

Ans so there is, according to Stewart, a real urgency to be able to measure intangible assets.

How to measure intangible assets: two paths?

And, Baruch Lev observes that: "*Intangibles are frequently embedded in physical assets (for example the technology and knowledge contained in an airplane) and in labour (the tacit knowledge of employees), leading to considerable interactions between tangible and intangible assets in the creation of value. These interactions pose serious challenges to the measurement and valuation of intangibles. When such interactions are intense, the valuation of intangibles on a stand-alone basis becomes impossible."*

In other words, the classical economic quantitative measurement methods are not working. What to do? How to find a way out and measure the intangible assets? Two ways are envisaged by economists today. Either we are trying to

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[8] Thomas A. STEWART : *The wealth of knowledge : Intellectual capital and the twenty first century organiszation* Nicholas Bradley, London, 2002. page 268-278. See also his first book : "*Intellectual Capital"* of 1997.

quantify the qualititive intangible assets. And this is what the majority of economists are doing. This is like trying to recuperate those new post indsutrial concepts into the classical "industrial" frame of thinking. It is truly understandable, although it is perhaps not the way to the future. Let us give here some examples: KPMG has even invented a mathematical formula[9]. Others like Leif Edvinson and Stewart himself, are proposing to rate the intellectual capital. Others like the Saratoga Institute are proposing a "Human capital index"[10].

The other alternative is to say: *"OK those intangibles are qualitative. This is almost impossible for classical economy to cope with. But we accept the situation and we try to invent an new economic approach which is more qualitative"*. Here we accept that we are in another values system. But the difficulty is that shifting to a immaterial qualitative approach will suppose a real paradigm shift in economic methods, and basic economic axioms. And there are not many publications going in this direction.[11]

Intangible assets become everyday more important.

Economists are discussing but the majority agree that the EU and US economies at least around 40% in the knowledge economy[12].

And so the proportional importance of intangible assets in the evaluation of a stock must be around 40% at least, and in many cases much higher.

The more we are entering into the knowledge economy worldwide the more the intangible assets will become important. It is like a huge buldozer avancing upon the industrial society and becoming dominant in a very short period.

Now we are in a strange situation where a bit less that 40% of our economic indicators are "intangibles" and immaterial and we still do not know very well how to cope with them, how to measure them, how to give them the due importance in the sorck markets.

Here is a graphic, that hes been prepared for a reasearch project financed by the European Commission, in 2003[13].

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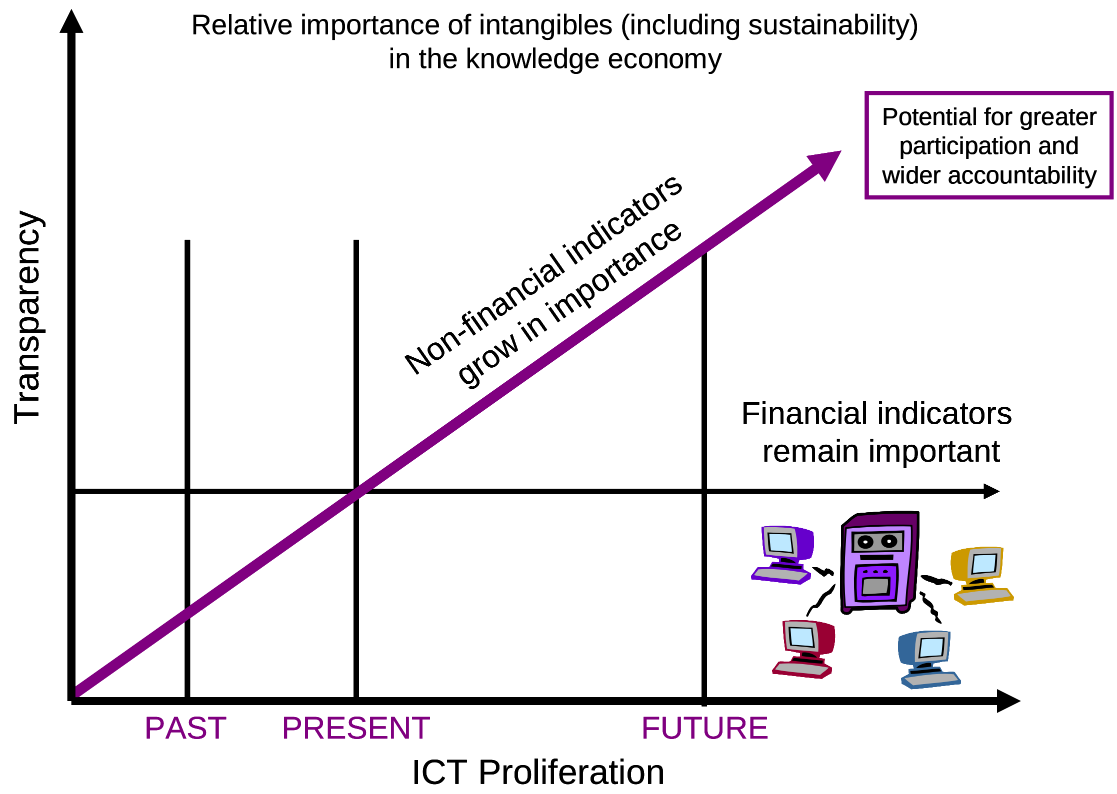
[9] See Thomas STEWART: *The wealth of knowledge* page 304.

[10] See http//:www.saratogainstitute.com. they call this index the *"Watson-Hyatt capital index"*

[11] One of the advanced in this new field of research is Verna ALLEE. See www.vernaallee.com

[12] A recent report by the Work Foundation in UK quoting Eurostat is explaining that:" *In 2005*, **just over 40%** *of the European workforce was empoyed by the knowledge-based industries. The Nordics and the UK (48 %) has the biggest shares of employment in the knowledge eoconomy. Sweden has 54% followed by Denmark (49,1%) and Finland(47,3%)*. Page 6. See "The Knowledge economy in Europe" prepared for the Council of Ministers of the European Union of spring 2007. http://www.theworkfoundation.com/Assets/PDFs/KE_Europe.pdf

[13] See: http//:www.neskey.com



This figure shows that intangibles were negligeable 10 years ago (Past). Today they have as much importance than tangible assets (Present) and in 10 years time (Future), they could become twice more important than financial (tangible) assets. We are thus in a rapid and important change and we *must prepare for it.*

But we will end this article with two good news. First, the more we are entering this knowledge economy, the more the content of the intangibles is evolving. The relative weight of sustainability and of social inclusion is growing in importance everyday.

The second is that stock market analysts are like forerunning the community of the economists. They use *their intuition to quantify* the intangibles, into the actual values of most entreprises worldwide.

Sustainability and social inclusion increase their shares in intangibles.

The more we enter in this world economic transformation, the more on one side we begin to feel more and more agressive reactions against this "new management", "those networks", this immaterialization, etc. Some of the industrial managers feel threatened by the changes going on. They more or less subscosicously feel that their power will diminsh and die...and they begin to react negatively.

But on the other side, I am puzzeld to observe that from year to year, as a dean of a Business School, I see that our students are becoming more and more sensitive and interested to orient their companies towards full sustainabilty and social inclusion.

Discussing also with some stock markets ananlysts, it becomes more evident everyday that the content of the intangibles are becoming more and more influenced by sustainability and social inclusion. The young generation is more and more eager to run companies which are "part of the solution". They do not want anymore be working in companies that are "part of the problem".

The shift is really quick, and the intangible assets are like the driving belt of this paradigmatic change. They push through sustainability and social inclusion in the business' agenda, through the stock markets.

Stock market analysts are measuring intangibles...everyday.

Yes, stock market analysts are in silence forerunning. They are since years and in silence measuring intangible assets. And speaking with them is very instructive. They are of a precious help in the transitional period.

We hope to be able to go further in this direction with some interviews of stock market analysts, in our next article.

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