INTEGRATED VALUE CREATION – PART 2

A PRACTICAL APPROACH TO CLOSING THE INTANGIBLE INFORMATION GAP

By Mary Adams, Smarter-Companies

Contents

This paper is the Part 2 of an examination of integrated value creation and the intangible information gap. Part 1 provides theoretical background that connects the integrated model with financial, sustainability and intangible capital reporting. Part 2 is oriented to practice and includes many examples and case studies. The two papers can be read independently.

THE INTANGIBLE INFORMATION GAP

In Part 1 of this series, I made the case that the integrated reporting movement has roots in three fields of study: Accounting, Sustainability and Intangibles. Accounting is a long-established field of study that is practiced by every company. Sustainability is much newer but has made dramatic advances in recent years. It focuses primarily on externalities, that is, the external creation and/or destruction of value related to a company's operations. By many estimates, more than 80% of U.S. public companies make some kind of disclosure each year of Environmental, Social and Governance (ESG) performance.

The third field of study contributing to the integrated reporting movement is called intellectual or intangible capital (IC). This field has primarily focused on internalities, the internal creation and/or destruction of value in a company's operations. To date, there are no broadly accepted standards for reporting or measurement of IC. But economic data suggests that these intangibles dominate corporate valuation. Since the 1970's the tangible net worth of the average company on the S&P 500 has shifted from explaining 83% of total corporate value to just 16% today. The remainder is what I call the intangible information gap.

The integrated multi-capital model advocated by the International Integrated Reporting Council (IIRC) is a solution to the intangible information gap. This paper outlines a methodology for using the multi-capital model to identify, measure and map value creation. It also includes a case study of the application of this process in a small association as well as numerous examples from public company integrated reports.

FILLING IN THE GAP – AN INTEGRATED APPROACH

In this section, I'll suggest steps that an individual company can take to use the integrated model to fill in the intangibles information gap. It starts with creating an inventory of the key value creation capitals (Matter), strategies for measuring the capitals (Measure) and emerging practices for mapping connections among the capitals (Model).

The discussion of these steps includes examples from public company reports and from the Exit Planning Exchange (XPX) a network of associations for privately-held companies and their advisors. I'm one of the leaders of the group and we've used this kind of integrated value management approach over the past several years. These examples are from our 2016 Integrated Report.

Matter

The first step in developing an integrated view is to identify or put names to the key components of each of the capitals, that is, *create an inventory of what matters*. As explained in Part 1 of this series, the corporate value creation ecosystem and process was easier to see in prior eras. Land was purchased. Buildings were constructed. Equipment was installed. Raw materials were purchased and converted to finished goods. It was all owned and tangible. We accept as obvious that companies would inventory all these assets. Not so with intangibles.

Intangibles information has to be created from the ground up. The first step is to create an inventory of the capital elements that fuel revenues, performance, collaboration and innovation: People who bring, create and apply knowledge every day. The partnerships with customers, suppliers who share and help you create and monetize value. The processes, data and knowledge that institutionalize best practices and make a company scalable. The use of natural resources. The social environment that is inevitably affected for better or worse.

Figure A on the next page is a recent capitals inventory for XPX.

Figure A – XPX Value Creation Inventory

XPX Global At Jan, 2017	PARTNERS ←→ Relationship Capital	PURPOSE Strategic Capital	PROPERTY Structural Capital	←→ PEOPLE Human Capital	←→ PLANET Natural Capital
	CUSTOMERS XPX Chapters	**VALUE PROPOSITION** Give Chapters the benefit of a shared brand, network and services while maximizing local control	**PROCESSES** • Chapter start-up • Event mgmt • Membership mgmt • Web site service and development	**COMPETENCIES** • Association mgmt • Community development • Social media	**RESOURCES** XPX Global is virtual so not significant user of natural resources.
Resource Inventory	**SUPPLIERS** • Wild Apricot (platform) • Supporting Strategies (fin) • WebBright (web development) • Stripe (paymts) • DigiCert (security)	**BUSINESS MODEL** • Service License fee based on gross revenues • No fees are payable until a new Chapter has sufficient cash	**DATA/IP** • Member profiles • Email list • Website • Manuals • URL's • Brands	**ADMINISTRATORS** • Donna Powell • Angie Ellis • Kathy Goodrich **MANAGEMENT** • Mary Adams • Dan Guglielmo • Shannon Zollo	**LAND** N/A
	STAKEHOLDERS • XPX Members • XPX Sponsors • Business Owners • Private Company Community	**CULTURE** • Professional • Collaborative • Learning • Adaptive	**BUILDINGS/EQPMT** N/A	**ADVISORS/BOARD** XPX Leadership Collaborative (incl representatives from all Chapters)	**WASTE** Chapters hold in-person meetings which implies travel and some paper use.
Metrics	7 Chapters 524 6559 contacts	Service license fee 35% payable when Chapter has >$7,500	15 member levels 36 major sponsors 68 events	3 virtual Admins 1 part-time Exec Dir 3 Founders	

Figure A summarizes the core capitals in XPX's value creation ecosystem. The company provides branding, technology and association management to a network of independent Chapters. The inventory seen here focuses on Global, not the Chapters themselves. Its customers are the Chapters and its staffing and systems are focused on supporting the Chapters. It does own the shared brands, two trademarks and a number of URL's. Since it's a virtual company, there isn't much of a tangible or natural capital footprint.

The format used for creating this table is available under a Creative Commons Attribution Share-Alike License. You can download a blank version at the Smarter-Companies website.

Although this kind of expanded, integrated inventory isn't a common practice today for public companies, it is possible to infer an inventory from public disclosure. Last year, I published a comparison of the capitals of Apple and Samsung as a way of illustrating different value creation models. This analysis highlighted the contrasts between Apple's design-focused model that outsources most manufacturing with Samsung's heavy investment in in-house production.

There are applicable financial measures for all the capitals on the income statement.

Measure

Once you create an inventory, the next step is to measure the listed elements. The three basic types of metrics are financial, quantitative and qualitative.

Financial

Accounting records all monetary flows into and out of a company. This has always been a critical activity because positive cash flows are the only way to ensure a company survives to continue its mission and achieve both external and internal sustainability. There are all kinds of information that can help measure the capitals starting with the revenues and operating expenses on the income statement.

The balance sheet is a little more problematic. As explained above, there's considerable financial investment in intangibles that doesn't make its way to the balance sheet. In our book, we called this intangible capital expenditure (i-capex).

There, we suggest that companies use accounting information on expenses to create a report of accumulated i-capex. I recently re-released the book chapter where we laid out the argument for i-capex. The World Bank used this kind of approach a few years ago to study the wine industry in Chile, confirming the importance of investment in intangibles to the industry's growth from a regional to an international player in the wine industry.

Financial data on i-capex can serve as a great starting point for intangibles measurement. It helps signal priorities and strategies of the company. And specific investments can be measured against different types of outcomes. This is an under-utilized alternative.

Quantitative

The most common tool for measurement of the non-financial capitals is counting things that can be counted. These quantitative metrics range from a simple set of key performance indicators (KPI's) to elaborate dashboards and performance management systems.

What are the right indicators? For human capital, a starting set of metrics might include the number of full-time, part-time and contract employees. Also relevant may be their tenure, education level and certifications. For relationship capital, the size and tenure of relationships with customers, vendors, partners. For intellectual capital, process performance (speed, volume, service levels), IP portfolio (number of patents, grouping by areas of expertise or knowledge families, number of licenses) and knowledge management statistics. For natural capital, carbon dioxide emissions, resource use, waste management are all common metrics.

Most companies already track countless key indicators. The goal of an integrated model is to bring them into a single view that connects with the capitals and develop a more holistic understanding of the system.

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Qualitative

Qualitative measures have been traditionally met with skepticism although their use has been accelerating in recent decades. The simplest one is the Net Promoter Score which has become an industry unto itself. Many ESG metrics are actually qualitative ratings and rankings performed by third parties based on questionnaire responses from companies. A large directory of these kinds of ratings is available at CSRHub. Other examples are the ratings of products on Amazon, hotels on Expedia and employers on Glass Door.

Due to our size, XPX doesn't have any external sources of qualitative metrics and we have yet to undertake any surveys to create our own. However, we do provide the simple scorecard for our key capitals seen in this figure. For now, the metrics we use are mostly quantitative and financial.

In a study I did last year of integrated reports, 7 of 10 included a summary data table similar to this one (although many just included a single year of data). My favorite example is Southwest Airlines, which provides five years of data (financial, quantitative and qualitative) about its capitals.

	2014	2015	2016
Relationship Capital			
Chapters	4	5	5
Markets Served	4	6	8
Chapters in Development	1	2	3
Members	301	370	524
Major Chapter Sponsors	n/a	36	43
Contacts	3,647	4,050	5,296
Strategic Capital			
Total Chapter Revenues	252,031	260,910	236,285
Consolidated Chapter Cash	100,535	117,600	105,841
Total Global Revenue	88,283	101,019	75,895
Consolidated Global Cash	39,162	24,570	29,243
Structural Capital			
Events	58	68	82
Articles on site	n/a	156	290
Videos on site	n/a	29	53
Full-length programs on site	-	-	7
Video views			97
Web visitors	10,725	10,203	15,216
Average page views	4.72	4.49	3.84
Average time on site	3.40	4.08	3.38
Human Capital			
Virtual Admins	2	3	2
Part-time Exec Director	-	1	1
Leadership Collaborative Meetings	6	6	6

Model

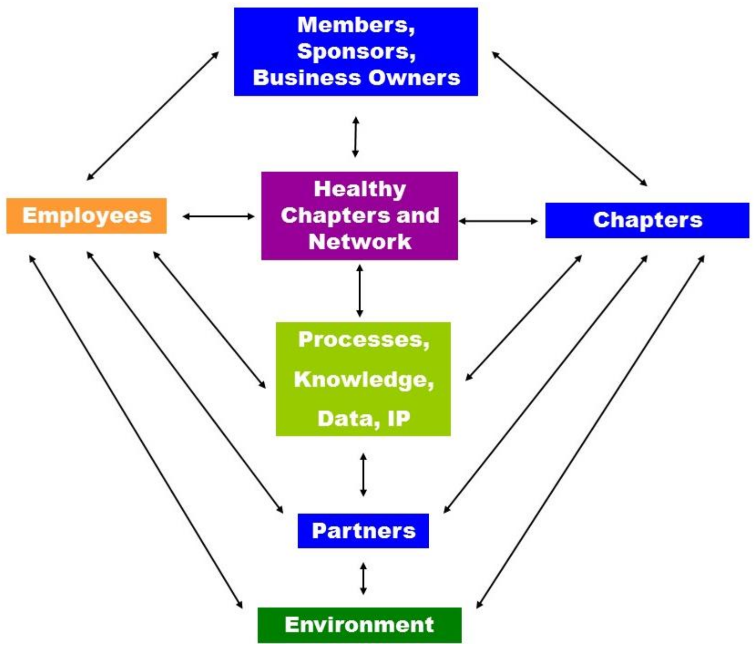
When you see all the capitals together, it is clear that financials, internalities and externalities are all interconnected.

The basic flows go something like this: Your company invests time and money to create infrastructure (the capitals) that it can use to create value for a customer. The customer pays for the value they receive with money (and other kinds of value flows) which enables the company to pay its bills and generate a return for its owners. Along the way, it creates and hopefully doesn't destroy long term value in the company's capitals and its environment.

But these value flows get complicated fast. To increase revenues, the company has to attract customers and good people. In exchange, they need to have a compelling purpose and value proposition. To solve social and environmental problems, they need to drive innovation. This requires them to hire good people, support them with a good culture, systems and, sometimes, external resources. To lower carbon dioxide emissions, they need to make changes in their physical plant but also processes, culture and people. Value is exchanged continuously.

At XPX, we keep the model simple. Our value map seen in this figure shows the basic flows. It's increasingly common for integrated reporters to provide a simple graphic like this. Here are some examples from Clorox, AEP and GE.

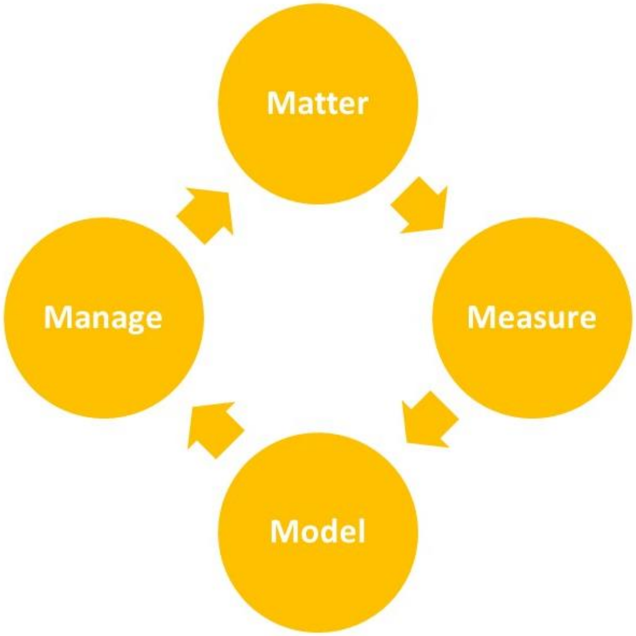
As mentioned in Part 1, there are already exciting advances in how to model value flows using the Value Delivery Modelling Language™ (VDML™) managed by Object Management Group® (OMG®), an international, open membership, not-for-profit technology standards consortium. There is actually a new software built using VDML called VDMBee that includes a capitals inventory based on the value creation inventory introduced in the example above. I hope that all this type of approach will be expanded in coming years through more robust analysis using standards like VDML.



Integration in practice

These steps are actually part of a circular, continuous-improvement management process:

- Matter – Inventory the most important elements of each capital
- Measure – Find the right measures to track how well the capital is performing and how it contributes to overall value creation
- Model – Explore more deeply the connections between the capital elements from all three perspectives: financial, internal and external
- Manage – Learn, make changes, improve wherever you can
- Return to Matter – Revisit to ensure you are delivering what your shareholders and stakeholders want and need



If you are like me, you'll look at the examples from XPX and various public companies as pretty primitive. They are. But they represent important first steps to identifying and communicating the connections between individual capital elements and how these flows create value for stakeholders and shareholders.

The ultimate goal is identifying all the non-financial, intangible drivers of shareholder and stakeholder value, and connecting them to the financials where applicable. We are a long way from providing a full accounting of this value creation ecosystem. But we are closer than we've ever been and improving all the time.

SOME BENEFITS OF INTEGRATION

The dominant focus of the integration movement today is on reporting, specifically public company reporting. But the IIRC asserts that its goal is to use integrated reporting as a means of driving more integrated thinking. As someone who has used a multi-capital model for over 15 years, I can attest that it indeed has applications beyond annual reports.

The inventory, measurement and modelling exercises outlined above have a number of applications. Here are some of the areas where I often see benefits together with data (in italics) from a study of integrated reporters by Black Sun in partnership with the IIRC called *Realizing the Benefits* (9/2014). The data in this report confirm that the integrated movement is about a lot more than just reporting.

Attract

Traditional branding was about "let me tell you what I think." Today, brands need to be a two-way street where a company actively listens to its stakeholders. And the story it tells has to be honest about why, how and how well it does what it does. An integrated model helps companies to tell a more complete story to attract good customers and smart employees.

91% see an impact on external engagement, 96% on internal engagement

Align

Every organization has a necessary distribution of labor to manage different kinds of capital. But it's dangerous if different roles and departments get stuck in silos. An integrated model puts all the different functions and capitals in a unified presentation. This helps teams connect the dots among the capitals in the value creation ecosystem to cut across organizational silos and increase teamwork.

78% see more collaborative thinking.

Accelerate

With the majority of corporate assets being intangible and outside traditional metrics, a lot is left to judgment about what needs to be done. Each person around a meeting table brings personal ideas from their own perspective. An integrated model helps teams develop a 360° consensus on how all the capitals are linked using financial, internal and external perspectives. This helps teams stop talking about what needs to be done so they can get to work doing it.

92% see increased understanding of value creation

Account

The intangibles data above highlighted the large intangible information gap. Financial partners fill in this gap with their own subjective analysis of the strength of a company, its outlook and risk profile. An integrated model helps control the conversation about the assumptions that drive the numbers. This helps companies communicate with bankers, investors and valuators to fill in the information gap and control conversations about corporate value and outlook.

87% believe financial capital providers better understand their strategy.

Avoid

As corporate value creation ecosystems have become more and more intangible, the risks to those systems are all more intangible and harder to see. An integrated model helps develop more holistic analyses to reduce systemic, reputational and organizational risks.

68% see better understanding of business risks and opportunities.

Act

Probably most important of all, the integrated approach enables conscious action, linking the values and purpose at the core of a company's mission to the outcomes it achieves and the health of its value creation ecosystem.

79% see improvements in decision making

CONCLUSION

Today, the tangible net worth of a company on the S&P 500 explains just 16% of its total corporate value with the remainder considered "intangible" and rarely measured in a systematic way. The multi-capital model used by the integrated reporting movement is a solution to this intangible information gap. This paper built on the deep dive into this information gap in Part 1.

In this Part 2 of the story, I introduced an integrated approach to filling in the intangible information gap. This includes: Matter – identifying key capital elements that drive value creation, Measure – approaches to measuring each element, Model – mapping the connections between the capitals and Manage – connecting back to the organization's core purpose, profitability and valuation.

This kind of approach is still in its infancy. The exciting addition of VDML should help increase the sophistication of the connectivity of financial and non-financial data. As time goes by, we'll get better and better at filling the intangible information gap.

Ready to try this in your own organization? Here's a downloadable worksheet to get you started.

Please note that additional briefing papers are available on the Smarter-Companies website.

Let me know if you want to explore how to apply these ideas in your own situation, Mary Adams, adams@smarter-companies.com, 781-729-9650