



Business for Social Responsibility

Business Brief: Intangibles and CSR

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Note:

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Business Brief: Intangibles and CSR

The link between intangibles and CSR is intimate and multifaceted. Understanding how value is created through intangible assets is integral to understanding how long-term wealth is created through CSR.

Background

This brief follows discussions at the BSR July 2005 retreat of member companies that focused on the future of business-society relations. At that event, the question of intangible assets (hereafter “intangibles”) emerged as a topic of keen interest to many of the participating companies. Like most in the business community, many sensed that intangibles are powerful drivers of value creation but, at the same time, they are poorly articulated, normally unmeasured and rarely reported. Further, the question of how intangibles relate to the CSR agenda was correctly identified as largely unexplored territory.

Each day in the capital markets and each year in the annual financial statements of publicly traded companies are reminders of how true these impressions are. The well-documented divergence between market capitalization and book value, the large price earnings ratios of technology stars such as Google and eBay, and the bids to acquire firms that substantially exceed value of physical and financial assets—all these trends attest to the role of intangibles in company valuation. Yet, notwithstanding the overwhelming evidence, little progress has been achieved in articulating and quantifying the intangible assets. This despite evidence that as much as one-third of portfolio managers’ investment decisions are based on intangibles.

Even less attention has been devoted to linking such intangibles to the CSR agenda. Intangibles such as reputation, trust and capacity to innovate—all widely recognized as fundamental to strong financial performance—are at the same time integral to the CSR agenda. Astute management of global supply chains, visionary environmental products and services, and proactive risk management through anti-corruption and HIV/AIDS initiatives are the kinds of practices associated with both CSR and quality of management. For the investment community, any determinant of quality of management is viewed as key to the overall assessment of company competitive prospects.¹

This brief is an opening exploration of the intangibles-CSR relationship and provides a framework for understanding this relationship. The brief begins with a mini-case, turns to definitions, and moves to illustrative intangibles initiatives and points of intersection between intangibles and CSR.

One Company's Story

Consider the case of Alcoa, the aluminum maker, as a story of the interplay among intangibles (in this case, leadership and innovation), one aspect of CSR (workplace safety), productivity, and financial performance, all in the context of a traditional manufacturing company.²

In 1987, Paul O'Neill (George W. Bush's first secretary of the treasury), took over the big aluminum producer Alcoa, when it was [per Business Week's Michael Arndt] "just another wheezing industrial giant with an unremarkable financial record and a workforce that was biding its time." O'Neill set about shaking things up, but he didn't focus on customary measures like profit margins. Instead he drove a stake in the ground on workplace safety. Alcoa, he proclaimed, would be the safest company in its industry, measured by time lost to workplace accidents. The following is Arndt's account of the results in early 2001:

"Alcoa's rate of time lost because of employee injuries was one-third the U.S. average when O'Neill took over. Today, it is less than one-twentieth. More important, O'Neill's emphasis on safety fundamentally altered Alcoa's culture. To meet his targets, managers and even bottom-rung workers began showing initiative instead of mutely waiting for orders. Productivity soon began rising, with a timely assist from the high-tech tools O'Neill also introduced, and then so did the financial tallies..."

"Today, Alcoa is the global leader O'Neill envisioned. In 1986, the Pittsburgh-based company recorded \$264 million in net income on sales of \$4.6 billion; it had 35,700 employees and a market cap of \$2.9 billion. When O'Neill retired at the end of 2000, at age 65, Alcoa boasted record profits of \$1.5 billion on sales of \$22.9 billion and a payroll of 140,000. Meantime its market cap—up 126% in 1999 when Alcoa was the top stock among the 30 Dow Jones industrials—stands today [2001] at \$29.9 billion."

The Alcoa story is impressive, but hardly unique. Examples abound: Nike's rebound from sweatshop controversies and ascent to global leadership in the apparel sector; BP's early and continuing leadership on climate change; Starbucks' longstanding employee benefits programs and more recent coffee sourcing programs. For each of these companies, brand and reputation were either at risk or strong, but not strong enough. While CSR professionals may view their actions as those of a responsible company, strategy and financial professionals may view them through the lens of fortifying intangible assets. The reality is they are both. All these examples attest to the inseparability of CSR and intangible assets. Investors intuit this relationship and customers respond to it, even while deficient accounting methods and financial reporting continue to play catch-up in a fast changing world in which intangibles frequently surpass tangible assets as sources of value creation.

Defining Intangibles

That no generally accepted definition of intangibles exists should come as little surprise. After all, such assets, unlike machinery and inventory, are not something a manager can kick, move and count. Nor do intangibles show up in any systematic way on the balance sheet, the profit-loss statement or cash flows. Intangibles, in other words, are not only intangible; they are largely invisible in relation to standard business management tools and disclosures.

Consider some alternative definitions:

- Intangible assets “drive economic performance. They don’t show up on a balance sheet or an income statement—yet, they are the manageable and usually quantifiable drivers of corporate-value creation.”³
- An intangible asset is a “claim to future benefits that does not have a physical or financial (a stock or bond) embodiment.” Intangibles can be divided along three major nexus, “distinguished by their relation to the generator of the assets: discovery, organizational practices and human resources.”⁴
- Intangibles are “nonphysical factors that contribute to or are used in producing goods or providing services, or that are expected to generate future productive benefits for the individuals or firms that control the use of those factors.”⁵

Two key threads in these definitions are non-physical and knowledge-rooted. Intangibles are rooted in human capabilities and are manifested in the relationships and the profile of organizations. They are assets that depend first and foremost on human creativity, not materials, and are transformed into enduring value for organizations by building know-how, capacity to innovate, and forming alliances and networks—all which lead to enhancing brand and reputation. In less technical terms, intangibles have been described as the assets of an organization that remain after plant, equipment and inventory is sold, the lights have been turned off, and doors locked.

A complementary definition of intangibles is offered through the lens of capital formation. One normally may think of a successful company as one that effectively protects, stewards and expands capital, whether it is financial, human or natural. But one may also look at capital through the lens of intangibles and ask: How do intangibles relate to different forms of capital, where capital is an asset capable of yielding a future stream of benefits? For this purpose, consider the following scheme:

- *Human capital* - knowledge assets, leadership
- *Organizational capital* - communications, strategy
- *Market capital* - reputation, brand development, alliances and networks, adaptability
- *Innovation capital* - R&D capability, technology

This scheme again underscores the pivotal role of human competency in building capital of the organization. Human, organizational, market and innovation capital all depend on human creativity, not the intrinsic value of physical assets.

Of course, intangibles by this definition have always played a role in value creation. From the earliest years of the Industrial Revolution, innovation has been the key driver of value, dating from the invention of the steam engine and onward to large-scale factory automation based on specialization of labor. But what eventually separated the winners from the laggards in the beginning of the 20th century was not scale of operations, but technical and organizational innovation. Scale followed, of course, in the case of automobile manufacturing, petroleum and telecommunications; but the root of the success was the capacity to envision systems, networks and markets sooner and clearer than the competition. In short, the *intangibles*.

When today's observers speak of the knowledge economy, the information economy and the services economy, such descriptors reflect the continuing ascendance of intangibles as key value drivers in the modern corporation. Competitive advantage resides in the minds of managers far more than the portfolio of physical assets of the organization. Indeed, in 1997, investment in intangibles (e.g. brand, training and R&D) exceeded investment in traditional tangibles (e.g. property, plant, equipment) for the first time. The former is estimated at about \$1 trillion per year. One need only observe the price-to-earnings and/or market-to-book ratios of companies like Microsoft, Google and Starbucks to see domination of intangibles in contributing to standard measure of value creation. And companies like Dell and Wal-Mart are sector leaders not because of scale per se, but because of their superior capacities to innovate in the areas of process improvements and logistics. Capacity to innovate—among the most potent of all intangibles—enables growth, not vice versa.

Many Initiatives, Elusive Consensus

Notwithstanding these trends, managers live in a world where intangibles remain under-recognized, under-managed and under-reported. While virtually every CEO is quick to point to human capital as the organization's primary asset, it is typically this asset that is first in the queue to feel the consequences of mergers and acquisitions. In government circles, measures of GDP are woefully inadequate in fully accounting for intangibles in national income accounts.

These inadequacies are not lost on leading voices in government and business. Alan Greenspan has observed that "...Over time, and particularly during the last decade or two, an ever-increasing share of GDP has reflected the value of ideas more than material substance or manual labor input." And Walter Wriston, former CEO of Citicorp, is even more to the point:

Post-industrial enterprises run on intangible assets, such as information, research, development, brand equity, capacity for innovation, and human resources. Yet none of these intangible assets appear on a balance sheet. This is another way of saying that, according to today's accounting practices, the worth of a brand name like Citibank or Ford has no value.

Various accounting standards bodies, such as the US Federal Accounting Standards Board and the International Accounting Standards Board, have dabbled with the intangibles question, but thus have failed to establish more robust measurement and reporting approaches. A related effort by the UK in the form of company law reform recently stalled at the end of 2005 after years of work to expand the required reporting of intangibles (in this case, negative assets or liabilities associated with social and environmental risk to investors).⁶

The Bridge to CSR

Much like intangibles, CSR also lacks a generally accepted definition. For some, it is simply a management approach in which the interests of all the organization's stakeholders are identified, assessed and respected. For others, and much akin to this first definition, CSR is a dynamic process of recognizing and responding to evolving norms of accountability between the organization and its stakeholders.

And BSR's definition, a useful point of departure, defines CSR as "achieving commercial success in ways that honor ethical values and respect people, communities, and the natural environment." This definition, like the first two, stresses the idea of recognizing and responding to a broader spectrum of stakeholder interests that includes, but is not limited to, shareholders.

A continuing and unresolved debate focuses on whether CSR is profitable. The answer, of course, is "it depends." The nature of the action, the company, the market, the cost and many other factors determine if a particular initiative yields net benefits in terms of standard measures of return on investment. But notwithstanding the case-specific nature of any CSR action, it is fair to say that intangibles play a significant and growing role in the assessment of value enhancement even if they seldom appear in quantitative form. This is promising because a significant fraction of CSR benefits are, in fact, of an intangible nature.

Absent a generally accepted definition, and reminiscent of the intangibles situation, CSR is often described more by its components, applications and illustrations than it is defined in a precise form. Again using BSR, a number of its programs are useful points of departure to describe how CSR manifests itself in the real world of managing the business:

- Human Rights
- Accountability
- Governance
- Community
- Environment
- Supply Chain

Human rights - Companies demonstrate a commitment to human rights through labor standards, worker rights, non-discrimination and participatory workplace environments. Such programs improve employee morale and productivity by building solidarity in the workplace and by cultivating and rewarding innovation among those closest to value creation. Reduced turnover and absenteeism build cumulative knowledge assets for the organizations.

Accountability - Accountability to all company stakeholders—employees, communities, investors, civil society—through engagement, disclosure and constructive responses is a precondition to business success. Accountability fosters trust, and trust, arguably a company's single most valuable asset, takes years to build but only days to lose. Research indicates the effects of accountability in the form of high standards of social and environmental disclosure on share price performance and share price volatility.⁷ Accountability enhances intangible assets such as brand, reputation, and employee and customer loyalty. Internal accountability has direct consequences on enlarging human and organizational capital in the form of strengthening workforce cohesion and motivation, key elements in retention and attraction of talent and deepening employees' potential and inclination to innovate.⁸

Take the Container Store, for example, a U.S. chain that expected to do roughly \$260 million in revenues for 2001. The Container Store was ranked number one on the Great Places [to Work] list for both 2000 and 2001; it won Workforce magazine's 2001 award for outstanding people-management strategies... Managers work alongside employees and employees help each other... Full financials are open for all to see. People learn central values, such as cultivating an "air of excitement," and repeat them to one another... [T]he result: Turnover is about one-third of the industry average for salespeople and about one-sixth of the industry average for managers. "A funny thing happens when you take the time to educate your employees, pay them well and treat them as equals," said president Kip Tindell. "You end up with extremely motivated and enthusiastic people."

Governance - CSR programs targeting corporate governance issues enhance a company's market and innovation capital. For example, increasing board diversity helps strengthen intangibles such as adaptability, alliances and networks. Diversity offers company leaders greater insights into customers and strengthens adaptability to shifting societal expectations. The converse also is true. The last five years are ripe with episodes of flawed governance in the form of failed internal control systems, fraudulent external reporting and abuse of firms' financial assets of cost investors, employees and pension-holders billions of dollars. Links between governance quality and financial performance increasingly is viewed as both a logical and demonstrable correlation, leading to a willingness of investors to pay a good governance premium in building stock portfolios. And in a signal of future developments, Brazil has established a separate listing for companies that meet high standards of governance, expecting this innovation to provide lower cost capital to companies that meet the test. Distilled to its basics, good governance depends upon a combination of leadership, competence and commitment, all of which are closely intertwined with the human capital of a firm.

Community - CSR programs that effectively connect with a company's community constituencies build marketing and organization capital. Companies with strong leadership and a clear strategic vision see communities not just as labor pools, but as assets to be managed with the same astuteness as capital and technology. Forward-looking companies no longer manage community relations with philanthropy, but partner with communities to help ensure a qualified workforce, adequate infrastructure and favorable decisions at times of facility location or expansion. Such organizations see communities as investors, not just hosts, contributing assets such as land, water and clean air essential to healthy and attractive workplaces, no less important than capital providers to sustaining business success. In the extractive sectors, communities are the linchpins for access to raw materials, without which companies' operations would cease. When access is denied, impeded or withdrawn for reasons of social or environmental conflict, oil and mining companies are robbed of their economic foundations. In a "CNN world," such conditions may become headline news virtually instantaneously, compromising brand and reputation and potentially threatening the license to operate even in areas not immediately affected by the company-community strife.

Environment - CSR programs that practice environmental stewardship contribute to market organization and innovation capital. Rating groups such as Innovest and GovernanceMetrics make the link between the quality of environmental management systems and performance and the company's overall quality of management. Demonstration of know-how in anticipating and managing environmental challenges appears to offer a useful surrogate for quality of management in general, one of the most sought-after attributes of a company among investment analysts.

Environmental stewardship also helps build and retain strong brands.⁹ With globalization continually driving costs and technology to convergence, the environmental character of the company and its products is emerging as a powerful discriminator when customers assess alternative products. While environment may never become *the* dominant attribute in the eyes of customers, its role as a powerful secondary and reinforcing product discriminator is undeniable.

Supply Chain - The role of supply chains in building and undoing brand and reputation needs little affirmation. The last decade has seen the emergence of supply chain management as one of the highest profile dimensions of CSR, and consequences will only intensify in the coming decades. Managing the supply chain through adherence to codes of labor practices, factory audits and disclosure of contractor factories are moving inexorably toward standard business practice. In the apparel industry where major brands outsource virtually all production, the performance of suppliers is inextricably linked to the reputations of the major brands that contract with them. Workplace conditions in Cambodia and Bangladesh have direct consequences for the financial performance of apparel makers in the US. The fair/ethical trade movements are creating workplace standards and transparency expectations unimaginable even a decade ago, notwithstanding the prior existence for decades of international and national labor standards. Companies in the consumer products business simply cannot risk tarnished brands through supply chain mismanagement. In contrast, organizational innovation and market capital strengthen—and are strengthened by—continuous improvement in the quality and efficiency of global supply chains.

Reflections

The portrait that emerges from the above is one of a closely knit relationship among intangibles, CSR and the capital formation process. While some researchers have examined the intangibles-CSR connection (sometimes explicitly, sometimes implicitly), the third element of capital formation has been subject to less analysis. This shortcoming warrants attention because in a world seeking pathways to sustainability, capital formation in all its manifestations—financial, human and natural—is indispensable to meeting the needs of future generations.

Looking at the synergistic relationship of intangibles and CSR and its pivotal role in capital formation helps open the mind of responsible companies and their stakeholders to a broader vision of what “responsibility” means. Business needs no introduction to the critical role of financial capital in running the enterprise. An appropriate mix of internal working capital through retained earnings coupled with adequate debt and/or equity capital are the preconditions to a successful enterprise. But this tells only part of the capital story. The less often told chapters are hidden in the non-financial capital assets of the firm—the intangibles—that CSR helps build, preserve and expand.

The limited and skewed view of capital formation is in many ways an outgrowth of the limited and skewed view of the purpose of the corporation. A byproduct of the ascendance of shareholder primacy during the last quarter century has obscured the pivotal role of non-financial capital. The continuous evolution and enhancement of non-financial capital is not only a core purpose of business, but a prerequisite to its durability and vitality. Yet the single-minded focus on financial capital, on the intermediaries who manage it, and the parties that accrue it has diverted attention from other equally—or arguably greater—sources of wealth creation through other forms of capital expansion.

This shareholder perspective obscures the critical role of intangibles. It diverts attention from the fact that both the efficiency and the quantity of production depend increasingly on organizational variables—the specific ways in which human beings and technology are brought together to yield products and services. The traditional concept of capital makes it difficult to grasp that human beings and their networks of interrelations are, in fact, society’s principal means of wealth creation. This observation is essentially the same observation that Adam Smith made over two centuries ago when he described labor as the ultimate source of wealth creation among nations. CSR practice strengthens and is strengthened by this recognition.

The perpetuation of the financial-centric view of capital is explained in large measure by its simplicity and inertia. Its simplicity is that “all” company assets can be elegantly reduced to the bottom lines of financial performance. Its inertia is that those who manage this particular form of capital are the same as those who benefit from perpetuating its dominance. This dominance is embedded in the received wisdom that financial capital rises above all other forms of capital as the key to an organization’s value. While this may be true in the terminology of the contemporary world of finance, it is at best a partial truth from the vantage point of building sustainable development.

The biases described here are at once a formidable obstacle and an enormous opportunity for CSR. Expanding the common understanding of capital formation to include a wide range of intangibles is at the heart of this challenge. Human, organization, market and innovation capital—all key drivers of business performance—share a common “gene” in that they are non-physical phenomena. Each of these are products of human intellect, of the employees who manage and operate the firm. Directly or indirectly these assets are subject to deepening and enrichment by CSR practices. Returning to the initial proposition put forward in this brief:

The link between intangibles and CSR is intimate and multifaceted. Understanding how value is created through intangible assets is integral to understanding how long-term wealth is created through CSR.

Endnotes

¹ Harry Hummels and David Wood, “Knowing the Price, But Also the Value? Financial Analysts on Social, Ethical and Environmental Information.” Nyenrode Business Universiteit and Boston College, September 2005.

² Jonathan Low and Pam Cohen Kalafut. *Invisible Advantage: How Intangibles are Driving Business Performance*. Perseus Publishing: Cambridge, MA, 2002, p. 56-57.

³ Low and Kalafut, p. 6.

⁴ Lev, Baruch. *Intangibles: Management, Measurement and Reporting*. Brookings Institution Press: Washington, DC, 2001, p. 5-6.

⁵ Blair, Margaret M. and Steven M.H. Wallman. *Unseen Wealth: Report of the Brookings Task Force on Intangibles*. Brookings Institution Press: Washington, DC, 2001, p. 9-10.

⁶ After several special commissions spanning more than 10 years lead to proposed revisions to Company Law, UK Chancellor of the Exchequer recently rejected recommendations to enlarge the scope of financial reporting by 1300 of the largest UK companies to include non-financial information Gordon Brown MP, Chancellor of the Exchequer, Speech at the Confederation of British Industries Annual Conference (Nov. 28, 2005) *available at* http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2005/press_99_05.cfm.

⁷ Lucy Greeves and David Lapido, *Added Value? Measuring the “Value Relevance” of Sustainability Reporting*. London, 2004.

⁸ Low, p. 171.

⁹ Global Environmental Management Initiative (GEMI), “Clear Advantage: Building Shareholder Value,” 2004.

About Allen White

Allen White in his Senior Advisory capacity with Business for Social Responsibility (BSR) has been charged with challenging both BSR and businesses engaged in the work of corporate social responsibility to think in new and different ways. In practice this has meant drafting a series of thought provoking public white papers and business briefs designed to serve as the catalyst for dialogue among the many stakeholders that affect, and are affected by the nature of business and society relations.