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# IC Rating

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**Introduction**

Today, most methods used to analyse an organisation are based on financial figures. The system used for financial reporting dates back to the 15th century, when Luca Pacioli invented double entry Italian bookkeeping. Mr. Pacioli´s system was later popularised during the industrial era, as it was widely appreciated for its clarity and auto-corrective features. Now, the information era is unarguably replacing the industrial era. Evidence of this is that an increasing share of company assets cannot be found in the balance sheet, like for instance patents, customer base, brand etc. Knowledge is the main source of competitive advantage; the management of a company is becoming more about managing people than it is about managing physical and monetary assets. Today's companies show only a limited amount of their assets on their balance sheet relative to the value they produce and they often apply different strategies than more traditional companies. The IC Rating™ was developed as a result of this development to try and better capture the unique aspects of the intangible organisation and to give companies a practical tool to use when discussing, analysing and measuring intellectual capital. With the current development it is obvious that complementary methods for measuring, analysing, managing and reporting are called for.

**What is intellectual capital?**

The intellectual capital field is awash with different terms, concepts and metaphors that can often be more confusing than enlightening. What is for instance the difference between intangible assets and intellectual capital? Do nonfinancial assets and immaterial assets mean the same? For the purpose of this chapter we will use the following definition for intellectual capital:

**"All factors critical to an organisation's future success**
**that are not shown in the traditional balance sheet"**

**The Intellectual Capital model**

The Intellectual capital model is originally based on ideas put forth by Karl Erik Sveiby in his 1997 book1 indicating a division in internal, external and market assets, and the groundbreaking work done by Leif Edvinsson at Skandia in the beginning of the 1990s. Most intellectual capital models today use this division, but the words and details might vary. Our model contains three main areas of intellectual capital; organizational structural capital, human capital and relational structural capital. These will be discussed in more detail below.

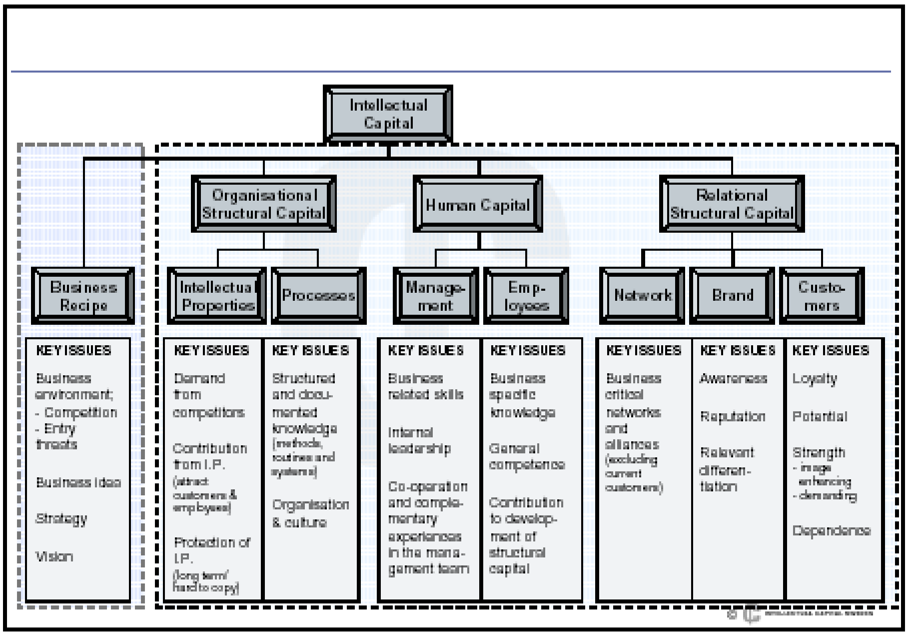

Figure 1 – The intellectual capital model

## Human Capital

The core of the IC model is the human capital. In the knowledge-based economy, this is becoming the most important intangible asset for most organisations. Key value drivers for human capital are employee knowledge, skills, abilities, innovativeness and experience. In today's marketplace, companies are looking for knowledge workers, for people with specific capabilities that they can apply within the organization. The key then becomes to capture that knowledge in the company's structures, so it is transferred from individuals, to groups, to the entire organization and becomes part of the organization's "structural" capital. As we will later see, this includes company practices, methods, and processes that yield competitive advantage.

The IC model further divides the human capital into two parts: the management and the employees. There are two reasons for this.
1) They have different roles. If you believe that optimizing your IC optimizes your future success, the role of the management must be to optimize the intellectual capital. The role of the employee is then to contribute to this intellectual capital. Research has for instance shown that 70% of the variation in the companies´ ability to retain key people can be traced to leadership and employee commitment.
2) Experience from working with the IC Rating™ has shown that the management is extremely central to a company's success. It is therefore separated out so that it can be analysed in more detail.

In the management box important factors like leadership quality, communication skills, strategic skills etc. are considered. Has Management fully developed its strategic as well as operational leadership skills? Does the Management function as well internally as externally? Does the company have the right Management in the light of the defined Business Recipe?

In the employee box, value drivers like loyalty, motivation, competence and experience are evaluated. Do the company's employees have the best conceivable expert knowledge to fulfil the defined Business Recipe? The highest rate of productivity? Are they willing to share and transfer their knowledge into structures. This is important since it is not the presence of knowledge itself that creates value, but when it is applied to the business.

Another important issue to highlight is that many believe that intellectual capital is only a measurement of how smart the employees are. Our model shows that Human Capital is a significant part of intellectual capital, but that there are much more to intellectual capital than the human capital part.

**Structural Capital**
In addition to the human capital, the model consists of two types of structural capital, the first being the organizational structural capital, or internal structural capital. Even if a company has the right human capital foundation, it will have difficulties sustaining business success without the right enabling structural capital. That's because without the knowledge transfer methodologies, processes and systems, the company is left with individual knowledge, not replicable, organization knowledge. It will also be difficult to succeed with external relationships without any supporting structures.

The IC Rating model divides internal structural capital in two parts:
The **intellectual properties** made up of patents, licenses, trademarks etc.
Some would say that this is the most refined part of the structural capital, as there could be a market for this and it can be bought and sold. This could provide the company with a temporary monopoly and give the company outstanding performance over a period of time.
The **process capital** is perhaps the most encompassing box of the model. It consists of all internal processes (recruiting process, marketing process etc.) models (project models etc.), IT-systems and documentation. Here the model looks at factors like whether the company has the most efficient tools and methods? Are all the processes structured and documented? If there is structure and documentation, to what extent are the processes actually in use?

In the IC model **culture** is also considered a part of the structural capital. Organisational cultural aspects include an evaluation of the rate of centralisation/decentralisation, how hierarchical the organisation is, whether or not the culture is expressed or more tacit, and to what extent visions, values and strategies are communicated in the organisation.

One of the main issues in intellectual capital management is, as previously discussed, to convert elements of human capital into structural capital. This transformation is crucial as structural capital can be owned by the organisation. Structural capital can also be leveraged to a greater extent and reduces the dependence on human capital.

It is however essential to have strong, well-developed human capital, because the major contact point with customers is through people or human capital. So it's the interplay between human capital, structural capital, and customer capital that results in the most robust intellectual capital.

**Relational Capital**
The third part is called the relational, or external structural capital. This consists of a company’s external relations:

1. Their network: suppliers, distributors, lobby organizations etc. When considering a company’s network it is important to look at issues like does the company have all the contacts needed for the organisation? If so, are these networks being utilised in the best possible way? Does the network give access to competence, finances, media coverage etc?

2. The brand. Here the model describes a company’s brand and not trademarks, which is part of intellectual properties. The model covers areas like attitude, preference, reputation etc. Is the company well known? Does the target group have great confidence in the company? Does the market perceive the company as having a significant competitive advantage in their brand.

3. Last but not least, the customers. This is in essence where your money is made, and it is one of the most important sources of competitive advantage. How the customers perceive you therefore become very important: Do they see you as a strategic supplier? A partner? Are your customers image-building in the sense that other companies might look to them to see who they buy from. Are they loyal and in it for the long term? Do you have a close relationship with them?

The more you know about your customers and the closer you are to them, the more difficult it will be for them to switch.

These three parts of the IC rating model together form what we call the ”operational effectiveness”. If an organisation has a very good operational effectiveness, it means that it is good at what it does, but it doesn’t necessarily mean that it is doing the “right” thing! The three different categories of intangibles must therefore to viewed in a strategic context.

**Business Recipe**

For most companies, the strategic context is expressed through their business idea and the strategy they choose to pursue in order to achieve that idea. Companies that have defined a vision and outlined the strategy for achieving this is in a much better position to determine what role their intellectual capital should play in achieving the vision. Different companies will define different roles for their intellectual capital. It is actually quite unusual to find two companies with the exact same roles for their intellectual capitals simply because no two companies have the exact same context. The set of roles that a company selects for its intellectual capital depends largely on the kind of firm it is, its vision for itself and the strategy it has chosen.

In the IC Rating™ model, Business recipe primarily contains three distinct parts:

**1) The Vision/Mission and business idea**
A company’s vision represents the long term goal of the company and a desired future state of the organization. The vision is often developed by top management and says something about their view on the company’s future development.

The business idea gives a more detailed formulation of the vision. The business idea focuses on the possibilities that exists in the company and is an expression of what differentiates the company from its competition. It also gives a more thorough description of what the company wants to achieve both short and long term with regards to for instance market needs, technology, customers and products.

**2) The business strategy**
The business strategy is a further operationalisation of the business idea. What are the company’s plans and activities in order to achieve their vision and strategy? Are they differentiated from the competition? Competitive advantages achieved based on the business idea are also sometimes included.

**3) The surrounding business conditions**
Different factors in the company’s business environment that will have an impact on the company, like for instance the competitive situation, the number of players in the industry, technological and environmental issues etc.
The business recipe is in essence the potential for the entire intellectual capital. If your organization has a weak business recipe, your operational effectiveness will be largely irrelevant. If your business recipe is strong this is a good starting point for a successful future provided that the operational effectiveness is strong.

## The limits of classification

This model is in essence a classification system and many find this type of model to be static and claim that such models seem to miss the essence of wealth creation, and that only a combination of these resources can create value[3]. The value, they argue, lies in the intangible assets' combined strength and not in their individual characteristics. Companies become unique and successful by combining various types of intangible resources and not by separating human capital from structural capital and customer capital from organisational capital. It is the synergy in the intangibles that creates uniqueness and wealth. We agree wholeheartedly with this argument, but also realize the practical limits of comprehension and have therefore chosen to divide them like this to be better able to analyse, measure and evaluate. The elements and parameters discussed and analysed in each box are however of a dynamic nature and look at the interaction between the different types of intangibles.

Finally it is worth noting that intellectual capital/intangible assets behave differently to physical and monetary assets. First of all they are not additive and monetary. It doesn't make sense to try to add up human capital with customers.

It is also pretty obvious that human capital, unlike financial capital cannot be owned by the organisation, it can only be contracted. The question then becomes, how do you as an organisation contract it, and how do you get your best people to stay? Are they motivated by high salaries, interesting and challenging work, an exciting corporate culture, or superior structural capital?

## The IC Rating™ tool[4]

Based on the intellectual capital model discusses above a comprehensive measurement and management tool was developed. In addition to the classification used in the intellectual capital model, the IC Rating™ looks at the company's intangible assets from three different perspectives, namely effectiveness, risk and renewal. A lot of the criticism directed at traditional accounting and financial management and measurement has been that it looks at history to try and predict the future. The IC Rating™ therefore consider three forward looking perspectives, and in addition to looking at the current effectiveness of the organisation, the model looks at the efforts and abilities to renew and develop itself and also at the risks that the current effectiveness declines.

1) Effectiveness looks at how well is the organization performing today and if the organisation is using their intangibles in the most optimal way.

2) Risk: The tool considers the threats that can be seen against the current effectiveness. It also looks at the likelihood of these threats occurring. In human capital the model would for instance look at how likely it is that key employees leave the company. If this is high it might be considered a threat, but it is also coupled to the sensitivity. The risk is higher if the person that might leave has knowledge/experience that is of crucial importance to the company.

3) Renewal and development looks at the effort to renew and develop present effectiveness. Here the model looks at factors like innovation and product development, education and development of employees etc.

Together the three perspectives illustrate the prerequisites for future success – the company's capabilities and potential. When combined with more traditional financial measurements, the IC rating™ can provide invaluable insights for owners and managers.

## Methodology

The methodology used for the IC Rating™ includes the evaluation of more than 200 intangible factors contributing to a company's performance. These factors are classified under the different parts of the intellectual capital model.

The structural capital is the capital type with most parameters. The purpose is to find the company specific key success factors with regards to the chosen or desired strategic context. In other words, the rating analyses whether the company has the right intangible assets to achieve what they want to achieve and if they are using them in the most effective way. As previously discussed, it also looks at the efforts to renew these critical success factors and the risks associated with them.

The main source of information is the company's most knowledgeable internal and external stakeholders. Personal in-depth interviews are therefore conducted with employees and management (internal) and customers, partners, government bodies etc. (external). The questions are answered using an 8-point scale and the respondents are also encouraged to provide a short explanation of their grade. Depending on the complexity of the rating, a full rating takes approximately 4-6 weeks to complete.

The rating result is then presented on three levels: 1) The executive level 2) The operational level and 3) The respondent level. These are explained below.

**The Executive Level**

This is an overall comprehensive summary showing the three perspectives **effectiveness** (i.e. a snapshot of how well your intellectual capital is performing today), the **risk** that the effectiveness decreases, and the **renewal,** i.e. how well your current initiatives are improving the effectiveness.

The grading is inspired by Standard&Poor´s terminology, where "AAA" is the best grade, and "D" is the worst. The coloured bars show the result of the rating. The higher the bar, the higher the rating. In the **risk** perspective, a lower red bar signifies higher risk than a high bar. Consequently, the higher the bars the better it is.

Below is an illustration of the executive level. For each of the boxes, the first bar shows the effectiveness rating, the second shows the renewal rating and the third bar shows the risk rating. The IC Rating™ result for this company is good with a relatively high overall effectiveness, strong efforts at renewal and a moderate risk. Strong competition in the industry and large powerful players are the main reasons for the relatively low effectiveness of the business recipe.

The company is however taking several steps to improve their business recipe, shown by the strong renewal efforts. The strongest area can be found within the human capital, where both management and employees show high effectiveness and very strong renewal efforts. The main reason for the slightly higher risk in management is the company's dependence on single individuals in the leadership team. Another relatively weak area is their processes. This comprises the company's internal processes in addition to the company culture and organisational characteristics. There is no rating result for the intellectual property as the company in the example has not defined any intellectual property for their business. This is a fairly common occurrence as the criteria for describing assets as intellectual property is quite strict.

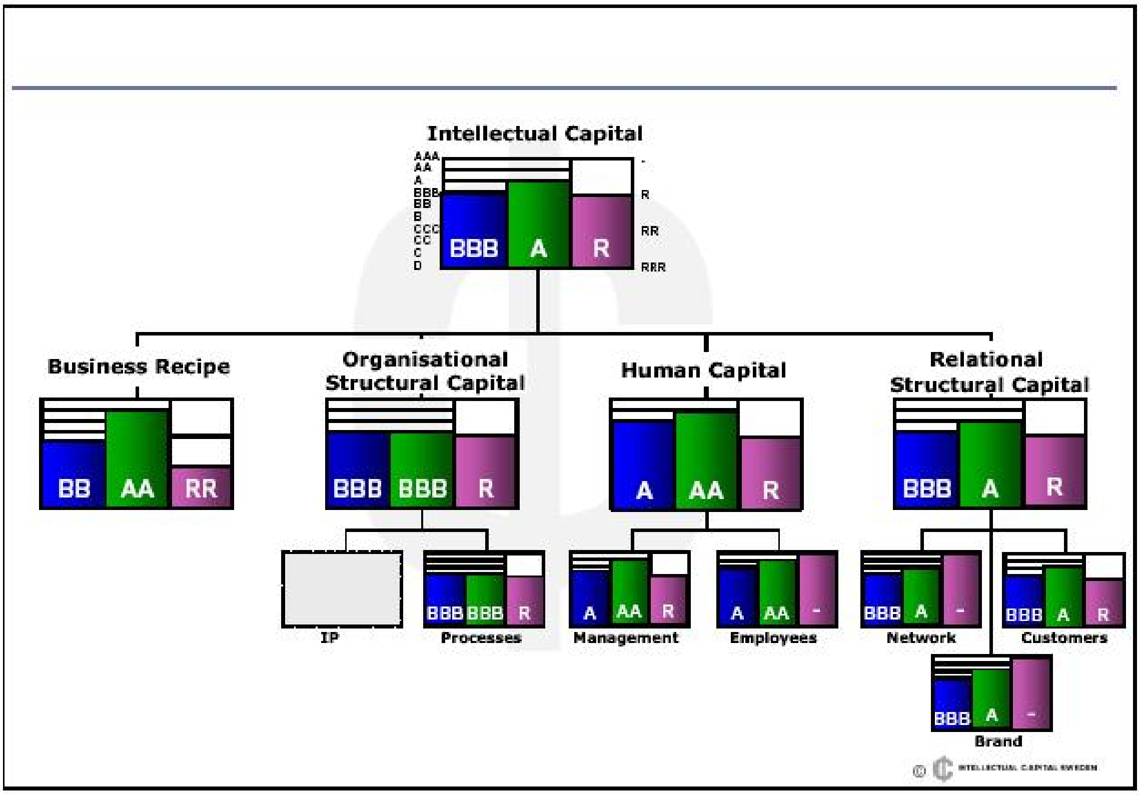


Figure 2. Example of Executive level

| Effectiveness | Renewal | Risk |
|---|---|---|
| AAA – Extremely high effectiveness | AAA – Extremely strong renewal | - Negligible risk of decline |
| AA – Very high effectiveness | AA – Very Strong renewal | R – Moderate risk of decline |
| A – High effectiveness | A – Strong renewal | RR – high risk of decline |
| BBB – Relatively high effectiveness | BBB – Relatively strong renewal | RRR – Very high risk of decline |
| BB – Average effectiveness | BB – Average renewal | |
| B – Relatively low effectiveness | B – Relatively low renewal | |
| CCC – Low effectiveness | CCC – Weak renewal | |
| CC – Very low effectiveness | CC – Very weak renewal | |
| C – Extremely low effectiveness | C – Extremely weak renewal | |
| D – Absence of effectiveness | D – Lacking renewal | |

The IC Rating™ scales/grades

## The Operational level

The operational level provides additional details. The IC Rating™ uses a presentation technique called a polar chart. Below is an illustration of such a chart. This is only an example and the parameters are taken from the customer box. Polar charts like this can be made using all of the factors considered in the rating and polar charts are made for all the different parts of intellectual capital. In this case a best competitor score has also been included. In order to create the polar charts the 1-8 scale of the grading done by respondents is converted to a 0-100 scale. The larger the number the better the score. This chart provides good inputs for more detailed discussions and can also form the basis for identifying important inputs to a business management system like for instance a balanced scorecard. The scores given by the respondents in the IC Rating can also be divided so that results from internal respondents can be illustrated and contrasted with the external respondents score on the same factors. The same can be done to highlight differences and similarities between employees and managers.

The company illustrated below is very vulnerable with respect to customers taking their business elsewhere. They are not perceived as being good at interacting with their customers either, but at the same time they seem to enjoy extremely good relationships with their customers. They also have quite a few image-creating customers.

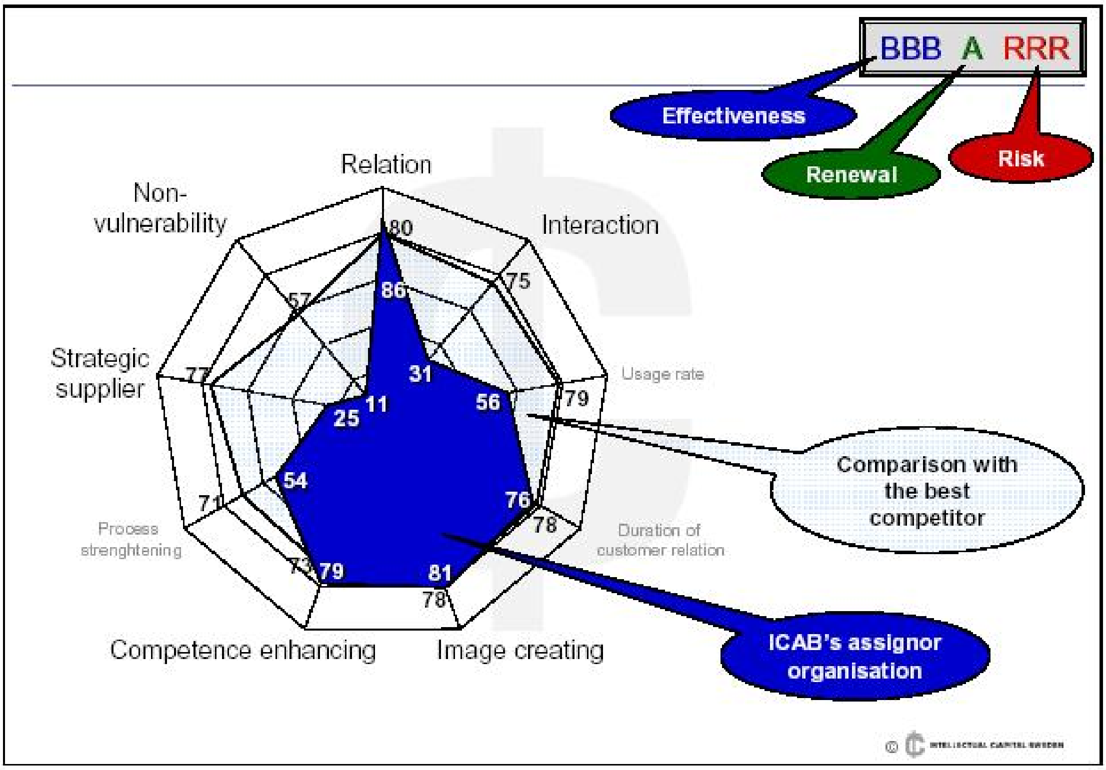


Figure 3. Result example operational level - Customers

## The Respondent level

In order to fully understand the operational level, an additional level of detail is required. The methodology therefore also includes a respondent level, which is a written document where respondents clarifying comments are anonymously categorized according to questions and categories. This is where all non-quantifiable knowledge appears. Clients find it very hard to argue with these comments, and find them very useful when analyzing the result.

**Benefits of using IC Rating**

The companies realizing the benefits of using the IC rating™ vary to a large extent both in size and industry affiliation. The clients range from large international players to small and medium sized companies and governmental agencies. Below are some of the reasons why companies choose to focus on intangible assets and using the IC Rating™.

First of all it gives the company **a better understanding of non-financial assets** and their importance in the company's value creation. As we have discussed earlier in this chapter, intangible assets behave differently to financial and monetary assets, and should therefore be treated differently. By having an intangible perspective we are able to bring new insights into how businesses change and perform and how intangibles interact to create value.

It also provides the people in the organisation with **a shared language and terminology**. Experience have shown that this is a very important aspect of the process as it provides the organisation with a structured and pedagogical way of discussing and understanding a concept that is often perceived as blurry and unclear. The important thing is however not the exact term used, but that a company uses the same language when discussing intellectual capital. Better **internal management** of intellectual capital is also a result of this process.

The IC Rating will show areas where improvements are necessary and it provides an excellent analysis and starting point for an internal measurement system that can be used to track performance and improvements over time. It also helps translate a business strategy into actionable results. Additionally it will help management to look at the whole company and not just the financial parts and establish a link between inputs, processes, the build-up of intangible assets and company performance. Most importantly it helps the management make intelligent trade-off decisions with regards to investments. Companies never have unlimited funds to invest in the company and the results of an IC Rating™ will give clear indications where the investments will give the best return.

The IC Rating™ also provides the organisation with an opportunity to **increase transparency** internally because the entire organisation becomes more aware of what is actually happening in the organisation. It also highlights the more tacit processes and ways of working that all organisations have, but that is not often discussed.

This is a good starting point for an external reporting framework. As we will see in the case study, Norsk Tipping actively use their IC Rating™ for external reporting. Their ambitious thinking in this area earned them the MAKE award both in 2003 and 2004. Many companies are reluctant to publish this type of information, but it is clear that it improves information to stakeholders about the real value and future performance of the company. It can also enhance the company's external reputation and market valuation.

**Henrik Martin** is the CEO of Intellectual Capital Sweden AB (ICAB).
Henrik holds a B.Sc. and M.Sc. in Electrical Engineering from Massachusetts Institute of Technology. His professional background includes working as a management consultant at McKinsey&Co, based in the Stockholm office. After leaving McKinsey, he became a key player in developing the internet consultancy industry in Northern Europe as Managing Director for the Nordic Countries at the stock-listed internet consultancy Adera.
Henrik joined as CEO at Intellectual Capital Sweden AB in order to internationalize the company, and has, amongst other things, been instrumental in setting up and implementing the

partnering strategy that has resulted in a partner network encompassing more than 20 partners on four continents. The successful implementation of this partner strategy has propelled Intellectual Capital Sweden AB to the leading position amongst Intellectual Capital practitioners. Henrik is a trusted advisor on IC related topics to many senior managers and board members around the world. He is also a much appreciated speaker on the topic of Intellectual Capital and its implications for the corporations of the 21st century.

**Peder Hofman-Bang** is Vice President of strategic alliances at Intellectual Capital Sweden AB (ICAB).
He holds a master of science degree in business administration from the Stockholm School of Economics. In 1992 his focus on the intangible parts of business commenced, as a management consultant within customer driven strategies. In 1997 he started ICAB together with among others Leif Edvinsson. Peder is the chief developer of IC Rating™ and he is a frequent speaker on the subject at various conferences (themes like Intellectual Capital, Intangible Reporting and Performance Measurement, Balanced Score Card etc).
Peder has participated in more than 150 intellectual capital related projects on four continents with focus on: mergers and acquisitions, strategy alignment, corporate governance, company development, operational risk and business control etc.
Over the last two years Peder's focus has been on the creation of ICAB's ICPC (Intellectual Capital Partner Community), a global network of IC practitioners. He has been instructing IC methodology to companies in Sweden, Finland, Norway, Germany, Italy, U.K., Japan, Australia, Taiwan, China, Thailand, Singapore, New Zealand, Poland, Denmark, Spain, France, Hong Kong, South Korea, Turkey, Slovenia and USA.