INTELLECTUAL CAPITAL REPORTING PRACTICES IN THE NON-PROFIT SECTOR

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CHAPTER 1

INTELLECTUAL CAPITAL IN THE NON-PROFIT SECTOR

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The chapter focuses on the definition and classification of Intellectual Capital (IC) and on the relevance of this concept within the non-profit sector[1]*. With this term in the book we mean all sectors different from the for-profit sector.*

CHAPTER 1. INTELLECTUAL CAPITAL IN THE NON-PROFIT SECTOR

1.1. THE DEFINITION OF INTELLECTUAL CAPITAL

The definition and classification of Intellectual Capital (IC) is still an open question (Zambon, 2004). To trace out a review of the most important definition of IC is something that goes beyond the scope of this work; what we want to underline is the "laterality" of the theme of intangibles.

Scholars interested in intangibles have dealt with the theme in relation to their research interests (such as the firm's evaluation, marketing, accounting, etc.), focusing from time to time on different aspects and also using different terminology (e.g. intangibles assets in the accounting field, intellectual capital in the managerial field).

In this work we are more interested in the definition supplied by management scholars (and in the evolution of the intellectual capital concept in this field) rather than in the evolution of the concept of intangibles and the way to treat them in the accounting field or in the field of firm evaluation (Tan *et al.*, 2008), because we are interested in the intangibles from a management point of view, that is, how intangibles should be managed in order to create economic value; it is not an accounting or a financial problem, but rather a management one.

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[1] Section 1 credited to Stefania Veltri, Section 2 credited to Giovanni Bronzetti.

The term IC is often used as a synonym for intangible or knowledge assets (Stewart, 1991). The term ‘capital’ makes reference to its economic roots, as the economist Galbraith who first used the term (Galbraith, 1969) described IC as a bundle of assets and a process of value creation.

The IC has its roots in the Resource-Based View (Barney 1991) and in the Competence-Based Theory (Hamel and Prahalad 1990) which, by shifting the search from outside to inside a company, recognized, respectively, the resources and competences as sources of competitive advantage. According to the RBV theory, among the firm’s resources, only rare, inimitable, firm-specific resources are able to generate competitive sustainable advantages, at the basis of the firm’s performance variations; these features are typical of the intangible resources (Lev, 2001). On the other hand, competence-based theory shifted attention to the competences needed to manage intangible resources. A subsequent evolution of RBV, the knowledge-based view of the firm, suggests that the firm’s primary rationale is the creation and application of knowledge (Grant, 1996). Strategically, the notion of IC is linked to the ability to create and apply the potential of an organization’s knowledge and knowledge is embedded in the many IC definition (Kaufmann and Schneider, 2004).

Consistently with the IC-based view of the firm, which focused their attention mainly on the knowledge intangible resources (and activities) and on the mutual interdependence between intangible resources in creating firm value (Reed *et al.*, 2006; Martín-de-Castro *et al.*, 2011) the notion of IC adopted in the book is a more complex notion, which includes intangible resources and refers to knowledge, but that does not coincide either with the intangible resources or with knowledge.

1. Therefore, we define IC as the dynamic and firm-specific system of intangible resources and activities based on knowledge, which, interacting with tangible resources, is able to generate competitive sustainable advantages, at the basis of the firm’s performance variations. From this definition emerge the intangibility of IC, its potential to create a firm’s value, the growth effect of synergies, the fact that the classification of intangibles changes over time (*dynamicity*), the fact that the articulation of IC is really different in relation to the sector, industry, typology, size of the firm, etc (*firm specificity*).

The theme of Intellectual Capital had a boom after the second half of the nineties, in which many definitions of intellectual capital were recorded, either by academic authors or by businessmen working with IC; other Intellectual Capital definitions also derived from important national and international projects focused on the theme of Intellectual Capital.

2. Historically speaking, if we focus our attention on the IC studies addressed to manage IC, we can identify two stages: the stage of *pioneering* studies and the stage of *advanced* studies. The IC definitions had an evolution passing from the *pioneering* studies to the *advanced* ones (Chiucchi, 2004; Veltri, 2007). In

the first level studies, undertaken by exponents of the consulting and business world to deal with problems connected to managing and reporting the intangibles which emerge in practice, the main aim is to explain, by analysing IC, the gap between firm market value and book-keeping firm value. Therefore the IC notion is an accounting one. Its nature is comparable to that of equity, but differs in that it is “borrowed” from the stakeholders. The studies of Edvinsson and Malone (1997) and Sveiby (1997) are classifiable as pioneering studies. Table 1.1 provides their definition of IC.

Table 1.1 – IC definition in pioneering studies

Authors	*Definition*
Sveiby (1997)	The gap between market and book value of the firm
Edvinnson and Malone (1997)	The gap between the firm’s market value and its financial capital (book value of a firm’s equity)

Whereas in the early stages the theorizations of IC were the prerogative of single companies or consultants, subsequently there were initiatives that involved policy makers and exponents of the academic world; experiments were carried out on a large scale and, in this stage, the aim was to manage knowledge by managing IC and to produce guidelines helping firms to draw up intellectual capital reports.

3. Among the many projects that have been launched, two have had the widest diffusion in Europe and are strongly accredited in the international literature and practice. These are the Danish Agency for Trade and Industry project (DATI 2000, DMSTI 2003) and the EU-sponsored *MERITUM* project (Meritum, 2002), considered advanced studies. Table 1.2 provides the DATI and Meritum definitions of IC.

Table 1.2 – IC definition in advanced studies

Authors	*Definition*
DATI (2000); DMSTI (2003)	No specific definition, instead the guidelines use the words ‘knowledge management’.
Meritum (2002)	The report underlines that IC includes both intangible resources (static notion) and intangible activities (dynamic notion)

All of the major players in the IC field share the idea that intellectual capital, from a qualitative point of view, can be divided into three categories, *structural capital*, *human capital and relational capital*. In detail, the first definition (Stewart, 1997), structures IC into three categories: human structural and customer. Only afterwards relational capital substitutes customer capital (Bontis, 1998).

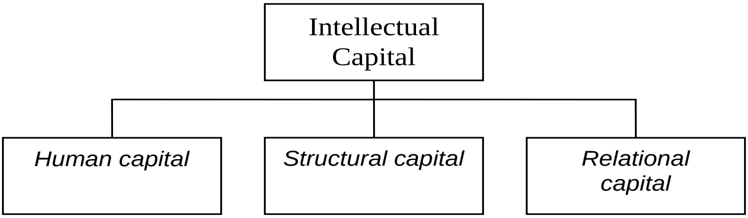

Figure 1.1 - The three-way division of Intellectual Capital

4. The categories represent aggregates of intangibles which are grouped by virtue of same characteristics, similar type of functions served and equal proprietary relationship with company (Chiucchi, 2004). Even if the labels utilized are different, the content of categories is more or less quite similar (Bontis, 2000).

5. Briefly, *human capital* (HC) consists in knowledge, capabilities, competences and skills possessed by firm workers; it is a kind of capital which is not the property of the firm, so the company needs to enforce the link with its workers as well as needing to find ways to transform the tacit knowledge into structured knowledge. Examples are innovation capacity, know-how and previous experience, teamwork capacity, learning capacity, formal training and education.

The *structural capital* (SC) is constituted of structured knowledge possessed by the firm and shareable (e.g. database, procedures etc.). Whereas human capital is possessed by the employees, SC is controlled, possessed and managed by the firm. In this sense, structural capital can be seen as the skeleton and the glue of an organization because it provides the tools and architecture for retaining, packaging, reinforcing, and transferring knowledge along the business activities (Cabrita and Bontis, 2008). In the IC literature often SC is divided into *technological or innovation capital*, addressed to the development of efficient production processes, as well as the advancement of the organizational knowledge base necessary to develop future technological innovations and organizational capital (R&D, technological infrastructure, intellectual property) and *organizational* capital, linked to organizational culture, organizational infrastructure, organizational culture, values and attitudes (Martín-de-Castro *et al*., 2011).

The *relational capital* (RC) is the totality of relations between firms and its main stakeholders. Examples of this category are image, customer loyalty, customer satisfaction, link with suppliers, commercial power, negotiating capacity with financial entities, environmental activities, etc.

6. As regards the articulation of IC in the pioneering studies, Table 1.3 provides the IC subcategories in the studies of Sveiby (1997) and Edvinnson and Malone (1997)

Table 1.3 – IC articulation in pioneering studies

Authors	*IC subcategories*		
Sveiby (1997)	Competences	Internal structure	External Structure
Edvinnson and Malone (1997)	Human capital	Structural Capital	Customer capital

According to Sveiby (1997), HC is identified with competences and can be defined as the capacity to act in a wide variety of situations to create both tangible and intangible assets. SC is identified with internal structure and is constituted of patents, concepts, models, computer and administrative systems, whereas RC is identified with external structure and includes customer segmentation, market growth, efficiency and stability. According to Edvinnson and Malone (1997), HC is defined as the combined knowledge, skill, innovativeness and ability of a company's individual employees to meet the task at hand; SC is the hardware, software, databases, organizational structure, patents, trademarks and everything else of organizational capability that supports those employee's productivity, whereas RC is identified with customer capital, included in the SC, and provides the relationships developed with key customers. It must be underlined that, despite the importance of the relationships being evidenced in the theory underlining the two conceptual framework examined, from a normative standpoint, the IC categories remain the principal, if not exclusive, object of reference (Chiucchi, 2004).

As regards the articulation of IC in advanced studies, the Danish Guidelines do not give a classification of IC, instead they give a classification of knowledge resources: *employees, customers, processes and technologies*. The Meritum report validated the three-way division of intellectual capital into human, structural and relational capital.

Although the categories are represented as separate, autonomous entities, it should be stressed that, theoretically at least, the value of intellectual capital is generated by the interaction among the categories. Nevertheless, pioneering models focus on content of IC categories, whereas advanced models focus also on relational flows between the various IC categories.

Summarizing, from a strategic point of view, IC becomes a crucial factor for a firm's performance in the knowledge-based economy (Kong, 2010), and this is even more true for the non-profit sector. We strongly believe that IC can provide a conceptual framework for managing non-profit organizations, as their main inputs and outputs are intangible in nature.

However, if IC assets are both nonfinancial and intangible in their nature, how can they then be identified, measured and managed? The financial statements are inadequate and the development of IC frameworks able to effectively measure and report IC assets is seen as a future research direction (Martín-de-Castro *et al*., 2011).

Table 1.4 - Meritum IC classification

	Content of IC subcategories
Human	The knowledge that employees take with them when they leave the firm. Includes the knowledge, skills, experiences and abilities of people. Some of this knowledge is unique to the individual, some may be generic.
Structural	The knowledge that stays within the firm at the end of the working day. It comprises the organisational routines, procedures, systems, cultures, databases, etc. some may be legally protected and become Intellectual Property Rights, legally owned by the firm under separate title.
Relational	All resources linked to the external relationship of the firm, with customers, suppliers or R&D partners. It comprises that part of human and structural capital involved with the company's relations with stakeholders (investors, creditors, customers, suppliers, etc.) plus the perceptions that they hold about the company.

Source: MERITUM, 2002

Typically, IC reporting frameworks have been analyzed through the lens of private sector organisations and there are no general frameworks conceived expressly for the non-profit sector; this has caused a lack of IC reporting studies within the non-profit sector. However, we believe, consistently with Guthrie *et al.* (2009), that this does not render the IC reporting framework less relevant for the non-profit sector.

The next chapter will focus on IC reporting frameworks in pioneering and advanced studies, underlining how the peculiarities of the non-profit sector could translate in the IC reporting frameworks.

1.2. DEFINING IC IN THE NON-PROFIT SECTOR

IC is one the key determinants of companies' business performance (Schiuma, Ordonez de Pablos, Spender 2007). In service organizations the role of IC is crucial because the outcome of activities is mainly based on intangible assets such as skill, personnel, fluent processes and other intangible factors (Kujansivu and Lonnqvist, 2009). In these organizations the financial aspect is not as important as the human and social one. Therefore IC management has been proposed as a new approach (Kong and Prior, 2008). Only recently tools have been applied to measure IC, but their importance in managing third sector companies is doubtful.

Validating the articulation of IC into the three subcategories of human capital, organizational capital and relational capital, the paragraph has the aim to decline these subcategories for the non-profit organizations, underlining the specificities of the third sector (Bronzetti, 2008; Bronzetti and Veltri, 2007).

Human capital (HC) can be defined as a set of aptitudes experiences and skills, knowledge, competences and skills possessed by firm workers (Bontis 1999, Bontis et al., 2002). It is not the property of the company but it is inside the workers. So it is necessary for the company to enforce the link with the workers to maintain this value inside the company. In the third sector it is a very relevant aspect to be focused on by managers, as it influences the correct running of a company.

The human resources structure of an NPO is more complex than a profit one and requires highly skilled managers (Melandri, 2003). In fact, there is a high intensity of labor with the peculiarity of employing two categories of workers: volunteers and paid workers. It is important for managers to be able to manage these two categories so that they co-exist harmoniously. Then it is especially important to manage volunteers who, sometimes and freely, work for the NPOs and who are the real added value of the sector. In fact, they do not cost anything to the company and work hard for an ethical objective. So managers have to be able to act on their targets and motivation.

In NPOs it is also important to consider that the use of human resources is increasing year by year, since there is a high demand for services. Often in NPOs the labor of weak people is used (such as the disabled, people with personal problems, young people not yet working) even if there is a scarce managing culture. In this context it becomes very important for the manager to increase human capital to achieve the company's mission.

Among the various aspects to be faced by managers in human resource management, there are some particularly important ones: skills, employee satisfaction and training.

Skills are formed by experience and the knowledge of activities. A third sector company is a labor intensive company, characterized by a direct relation between the operator and the end user, so the quality of services offered, which underlies the creation of a company's sustainable competitive advantage and the forerunner of the organization's value, is highly dependent on the skills of the employees.

Employee satisfaction includes the chance to achieve the company's mission. This is a very important intangible aspect that differentiates NPOs from for-profit companies. In NPOs the financial aspect is not in the first position as the social mission. So managers have to act on this aspect that may be synthesized as the awareness of achieving a social target.

Training is strictly linked to the other features (skills and employees satisfaction) as they can be reached only through an intensive training activity. It is important to spread and to maintain workers knowledge. So the senior workers have to train junior workers in order to maintain knowledge internal to the company. Then, HC is important also considering that NPOs are continuously facing multiple stakeholders with different expectations. In this context the capability of the NPOs' managers to deal with responsiveness and accountability become fundamental to ensure a long lasting life to the organization (Balser and Mc Clusky, 2005). A correct management of HC helps manager to properly answer to the different stakeholders' expectations within the organizations mission and values.

Structural capital (SC) can be defined as a supportive infrastructure for human resources (Benevene and Cortini, 2010) and includes, among the others, the company's knowledge, organizational structure, procedures, management philosophies, organizational processes systems and informational resources. These are all relevant aspects both in for-profit organizations and in NPOs.

There is a strict link between HC and SC and it represented by the organizational culture that is the basis for organization's management. Organizational culture represents the framework for a correct management of the company, such as defining the activities breakdown and the methodology to perform job tasks.

In NPOs structural capital is important as these companies are created to meet the needs of a specific group of people often with limited financial resources. In this context NPOs culture is built around delivering services and not addressing strategic issues (Borzaga and Fazzi, 2000) so it happens that NPOs are focused on efficacy and efficiency of services and not on knowledge and this is not sufficient to create new knowledge (Weick, 2001). NPOs must not only learn new knowledge but also drop outdated knowledge (Kong, 2009). Knowledge and organizational culture are fundamental and function as an effective coordinating mechanism that supply to human resources a strong organizational identity, a leadership style, oriented to the workers' involvement and development. The new technologies allow on-line communication between citizens and (NPOs) and create a link to share information and knowledge, improving the effectiveness (Guerzoni *et al.*, 2005).

Knowledge as well as organizational culture helps the relation between internal and external stakeholders. To manage relationships with multiple stakeholders with different expectations suggests the formal mechanism to be used to improve communication channels between the NPO and its stakeholders (Ospina *et al*, 2002). These mechanisms include also missions, value, culture, organizational culture and employees' satisfaction (Kong, 2007).

For structural capital managers must focus their attention on these aspects building indicators to evaluate performance (Bronzetti and Veltri, 2007). Indicators should be company culture, changing and innovation skills.

Company culture includes numerous meanings, such as ideas, ethic, and languages. Company culture is a part of the IC representation. It may be considered an efficient coordination system when it spreads confidence, and involvement. These components are very important in NPOs where ethics is much more important than financial targets. Changes and innovation are other relevant and successful IC components for attaining a competitive advantage.

Another relevant component of IC is relational capital (RC) composed of all the resources linked to the relationship with external stakeholders. It includes the exchange of knowledge between the NPO and its external stakeholders (Grasenick and Low, 2004) as well as the perception they have of the organization. A good relationship with stakeholders implies an improvement in the firm's trust and reputation and so an increase in RC.

The same features are relevant for a profit organization as for NPOs, but in the latter, RC is crucial as these live with external funding, volunteers support and need public trust for legitimacy (Alexander, 1998). Consequently this IC component should be managed properly to avoid the loss of external valuable resources (Ospina *et al*, 2002).

Kong and Prior (2008) presented a comprehensive framework to account for the IC-based competitiveness of non-profit organizations. The IC conceptual framework provided for NPOs underlines that organizational value is created by the interactions of the three IC categories (Benevene and Cortini, 2010).

As shown in figure 1.2, Kong and Prior's IC conceptual framework emphasizes the stocks and flows of knowledge within and outside the NPO and links these knowledge flows with plausible implications for value creation.

The new competitive environment has led NPOs to think about new management tools. Nowadays efficiency and effectiveness are crucial in the management of NPOs. These features highlight how a proper understanding of the IC framework may be very helpful to face the new challenges. The IC conceptual framework supply several strategic advantages to NPOs. IC components enable NPOs managers to conceptualize better the strategic significance of knowledge and intellectual resources in their organizations. In for-profit organizations profit serves as a simple common language for communication, delegation and co-ordination, and as a means to measure organizational success and benchmark performance. Differently, in NPOs management techniques that stress cost savings and value for money cannot be simply applied. It is the different aims which drive NPOs managers to think of their organization in a different way.

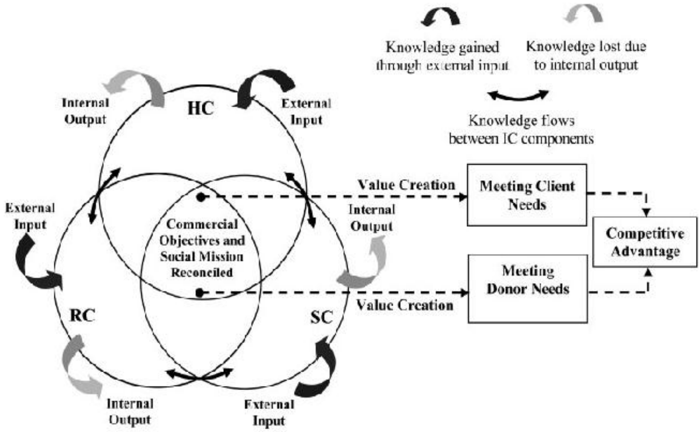

Figure 1.2 – The Kong and Thomson's (2008) IC framework
Source: Kong and Prior (2008)

A proper IC understanding and management is important as these assist managers to refocus their objectives on a social dimension often distorted by operating in a commercial environment (Kong, 2007). IC management allows social objectives to be pursued and simultaneously their resources to be managed effectively without resources and goals dispersion, which often happen in an NPO. It also emphasizes the importance of external knowledge input and helps to create a learning culture.

Lastly, it must be underlined that, while the Kong and Prior (2008) framework creates an excellent basis for further discussion it also raises a question about the role of the industry. It can be assumed that, from the IC management point of view, the distinction between different industries may in some cases be as important as profit orientation (i.e. for-profit vs. non-profit). Thus, more research is needed to understand the specific role of IC in different sectors of the non-profit arena and the following chapters are devoted to exploiting the theme of the IC framework and IC reporting within each non-profit sector investigated, after having provided a general framework of IC reporting models to which NPOs refer in drawing their own IC reports.

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