What if companies fail to recognise the value of intangible benefits?

Putting a number on intangibles such as human capital, brand strength and corporate social responsibility is tricky. But 21st century businesses need to find a way.

The 20th century firm was predominantly capital-intensive and the key assets were physical – factories, land, and machines. The key challenge for shareholders (and society) was to ensure that managers did not misuse corporate resources for their own benefit, for example by paying themselves excessive salaries, building empires through value-destructive acquisitions, or simply shirking and enjoying the quiet life. As a result, investors focused on closely monitoring management – using financial statements to measure a firm's physical assets and current profits, and tying executives' pay to short-term performance.

The world has changed. The key assets in the modern firm are intangible – human capital, brand strength, R&D capabilities, and corporate social responsibility (goodwill with one's customers, suppliers, employees, and regulators). These assets cannot be reduced to simple numbers on a balance sheet, nor do they show up in short-term profits – instead, their benefits may take several years to manifest. The focus on measurement, while appropriate for the 20th-century firm, backfires with the 21st-century firm. Evaluating managers according to tangible short-term measures will cause them to ignore the intangible drivers of long-term value.

Organisations face a dilemma. On the one hand, maintaining traditional monitoring systems will lead to myopia. On the other, scrapping them will give managers free rein to act in their self-interest. The solution is to find new ways of evaluating managers that both free them from a focus on short-term numbers, and at the same time still hold them accountable to maximising firm value. One strategy is to give executives stock and options with long vesting periods, to tie them to the long-run health of the firm.

But it's not only down to the companies themselves – change must be systemic. Investors and equity analysts must de-emphasise quarterly earnings announcements and instead evaluate firms according to non-financial metrics, such as environmental stewardship, employee welfare, and supply-chain sustainability. Regulators should curb the trend to ever-increasing disclosure, since the key indicators of firm value cannot be reduced to simple numbers.

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