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**Recent Developments in Intellectual Capital Reporting and their Policy Implications**

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## ABSTRACT

This paper provides a survey of recent developments in the reporting of intangible assets. It finds that rather than the wholesale restructuring of the accounting model that was proposed years ago, the trend has been to address gaps in reporting with new forms of reporting. New forms of reporting appear better suited to capture the type of information that users of intangibles data seek.

Financial reporting standards continue to change both at the national and the international level with the result that they are better able to capture some types of intangibles data. Even so, some areas such as human capital remain difficult to reflect in traditional financial statements. Users interested in human capital information are much better served by reports that are tailored to their needs, and by reporting techniques that take into account the specificities of human capital.

On the policy front, companies are receiving considerable encouragement to provide more information on the intangible drivers of corporate performance than ever before. In Europe, part of the impetus has been the Accounts Modernisation Directive, which requires an “enhanced director’s report” that can include a discussion of human capital to the extent that directors feel that it is important for a full understanding of the business and its performance.

There appears to be a trend to report beyond the limits of what traditional accounting standards require, and include a broader set of important value drivers. The question has moved from whether this information is important and whether it needs to be reported, to how to best report it.

A number of standard setters now provide guidance on how to better report on important performance drivers, including intangibles and human capital. Much of this new reporting is expected to appear in management’s discussion and analysis (MD&A) or its equivalent, and is expected to be subject to board-level review.

Future developments can be expected in a number of areas including the further enhancement of reporting techniques, development and agreement upon a conceptual framework for intangibles reporting, and eventually the development of reporting taxonomies for XBRL (Extensible Business Reporting Language), which should allow for easier, more uniform, and cost-efficient reporting.

## RÉSUMÉ

La présente étude s'attache aux évolutions récemment observées dans la diffusion d'informations sur les actifs incorporels. Selon les conclusions de cette étude, plutôt que de procéder à la restructuration globale du modèle comptable proposée il y a plusieurs années, la tendance a plutôt consisté à combler les lacunes en matière de publication d'informations à l'aide de nouvelles formes de diffusion. Ces nouvelles formes apparaissent en effet mieux adaptées pour appréhender le genre de renseignements que recherchent les utilisateurs de données relatives aux actifs incorporels.

Les normes de publication d'informations financières continuent à évoluer, au plan national comme international et de ce fait, elles sont aujourd'hui mieux à même de saisir certaines catégories de données incorporelles. Cela étant, même dans ces conditions, il reste difficile de refléter dans les états financiers traditionnels certains domaines tels que le capital humain par exemple. Les utilisateurs intéressés par des informations sur le capital humain trouvent davantage ce qu'ils recherchent dans des rapports conçus en fonction de leurs besoins et à l'aide techniques de publication d'informations prenant en compte les spécificités du capital humain.

Sur le front de l'action publique, les entreprises sont très fortement encouragées à fournir davantage d'informations sur les moteurs incorporels de leur performance qu'elles ne l'ont jamais fait auparavant. En Europe, une partie de l'impulsion a été donnée par la Directive sur la modernisation des directives comptables, qui rend obligatoire la publication d'un rapport plus étoffé du conseil d'administration, lequel peut comprendre un passage consacré au capital humain si les administrateurs l'estiment important pour la bonne compréhension de l'entreprise et de ses performances.

Il semble que la tendance soit à la publication de rapports allant au-delà de ce que les normes comptables traditionnelles imposent et à la prise en compte d'un ensemble plus large d'éléments notables créateurs de valeur. La question n'est plus de savoir si une information est importante et s'il convient de la publier, mais bien de savoir quelle est la meilleure manière de la diffuser.

Un certain nombre d'organismes normatifs fournissent aujourd'hui des orientations sur la manière de rendre compte au mieux des moteurs de performance importants, en particulier des actifs incorporels et du capital humain. Une grande partie de ces informations nouvelles vont sans doute figurer dans les rapports de gestion ou leur équivalent, et devraient être examinées au niveau des conseils d'administration.

D'autres évolutions sont à attendre dans un certain nombre de domaines, notamment la poursuite de l'amélioration des techniques de publication d'informations financières, la mise au point et l'adoption d'un cadre conceptuel pour la publication d'informations sur les éléments incorporels, enfin, l'élaboration de taxonomies de diffusion d'informations en format XBRL (eXtensible Business Reporting Language), qui devrait faciliter la publication d'informations, en améliorer l'harmonisation et la rendre plus rationnelle en termes de coûts.

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## RECENT DEVELOPMENTS IN INTELLECTUAL CAPITAL REPORTING AND THEIR POLICY IMPLICATIONS

### 1) Introduction

This paper provides an overview of some of the recent developments in intellectual capital reporting with special consideration given to the role of human capital. The topics of intangibles, human capital and intellectual capital have formed the basis of considerable debate for a number of years. Part of the interest is because of the emerging perception that intellectual capital is the fundamental driver of corporate performance in a modern economy. Formerly, physical capital was viewed as the primary source of the wealth created by enterprises. Then, towards the later part of the 20<sup>th</sup> century, it became apparent that companies such as Microsoft, Google, or Genentech, companies of the “new economy,” could generate enormous wealth with scant investment in physical assets. They were generating wealth with intangible assets. When these “dematerialised” companies shot to the top of the lists of stock market capitalisation, they not only toppled their manufacturing competitors, but also turned past notions of what constitutes an asset and how value is created on its head.

The challenge to improve intangibles reporting is often presented as a necessity arising from of the emergence of the “new economy”. In the new economy, companies compete based on knowledge and technology. Some observers question whether the new economy is really so new. They argue that there was an important knowledge component in the “old economy”, although concepts of knowledge management did not yet exist.<sup>1</sup> Even if knowledge always played an important role, changes in the economy make them more important today. Knowledge, technology and innovation as factors of production, and the growing importance of the service sector all make the interest in intangibles more acute.

The macro-economic effects of intangibles have also captured the attention of policy makers. Some countries invest more in intangible assets than others do, and seem to enjoy higher levels of growth. This has led other countries to encourage investment in intangible assets in order to enhance their competitiveness. There are also concerns regarding the efficiency of capital markets; the absence of information on a key corporate performance driver should result in information risk and less than optimal decision-making. If key assets are not understood or underreported then efficiency, it is argued, will be hurt.

Human intangibles or human capital has been shown to have a disproportionately large impact on company performance compared to other intangible resources.<sup>2</sup> Some studies even suggest that human capital is the key determinant of value. This view is echoed by executives who claim that a company’s greatest assets are its employees. Human capital also stands out for the difficulty in measuring how humans create value, and in developing conceptual models for how people contribute to financial capital.

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<sup>1</sup> Upton, W. (2001), Special Report, Business and Financial Reporting, Challenges from the New Economy.

<sup>2</sup> Tamkin, Penny (2005), Measuring the Contribution of Skills to Business Performance, Institute for Employment Studies.

There is also a broad consensus among business leaders, the markets, academics and regulators on their importance. Human resource intangibles are arguably the most important among the broader category of intangibles since they are the unique sources of all knowledge, creativity and innovation. At the same time, human intangibles are, conceptually, some of the most difficult to fit into the value chain. They are also among the most difficult to report on—at least according to the criteria established by traditional accounting. The result is that economic decision-making is made difficult because of problems in measuring intangibles and human capital, and in understanding cause and effect relationships. Intangibles reporting has received considerable attention in order to encourage better intangibles management by companies, better accountability for these key resources and more efficient investment decisions both within firms and within the capital markets.

A large number of studies document the benefits of transparency and the costs of poor information, and many studies demonstrate a link between information on intangible assets and investment decisions.<sup>3</sup> Problems associated with incomplete or inadequate data on intangibles can be divided into three principal areas: 1) inefficiencies in corporate operations; 2) corporate governance, and; 3) distorted investment in the capital markets.

On the company level, there are indications that investments in intangibles do not receive the same attention from managers as investments in fixed assets and that internal investment decisions investment can be distorted as a result. This is reflected by the well-worn phrase “you manage what you measure”. The fact that some important factors of production (principally human capital but also brands, R&D, and patents) do not appear in the accounts may mean that the management and the stewardship of these factors do not receive the attention they require. While it would be inaccurate to portray the human resource department of enterprises as a simple cost management function (most companies recognise the importance of human resources and try to manage them proactively to best effect) the traditional treatment of human resources as costs has impeded the advancement of a mentality that human resources are assets and that expenditures on them have the characteristics of investment.

There is also evidence that a focus on short-term profits may have a negative effect on the investment decisions taken by managers. A study by Graham, Harvey and Rajgopal shows that managers often delay or forgo investment in sound projects (projects in which there was a positive net present value) in order to “manage” quarterly earnings and meet market expectations.<sup>4</sup> This behaviour occurs for both tangible and intangible investments. It could, however, be postulated that intangible investments, and human resource investments, in particular, may be prone to being viewed as discretionary since they are traditionally viewed as costs.

Corporate governance is another area where reporting could be having an impact. Boards of directors are accustomed to receiving financial statements and reports on traditional assets, but not on intangible asset. Certainly, the directors of companies with high levels of intangibles in their business model, such as consumer goods companies, are more likely to be aware of the value of brands and reputation. They will also be more aware of risks associated with these important assets. There is, however, legitimate concern regarding whether directors are paying sufficient attention to intangible assets.<sup>5</sup> Better information on intangibles may thus promise better stewardship at the board level and better accountability for what really counts in the enterprise.

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<sup>3</sup> For a summary of some of the key studies, see the Study On The Measurement Of Intangible Assets And Associated Reporting Practices (2003), Prepared For The Commission Of The European Communities Enterprise Directorate General.

<sup>4</sup> Graham, Harvey and Rajgopal (2005), The Economic Implications of Corporate Financial Reporting.

<sup>5</sup> Frederick, W. (1998), from interview conducted with Mary Keegan, Partner, PriceWaterhouseCoopers.

In addition to these concerns, many have argued that the underreporting of intangibles creates distortions in external investment decisions. The reasoning goes that if expenditures with investment characteristics were not recorded as expenses, investors might consider them as positive contributors to firm value. A number of the reports and studies described below discuss using better intangibles reporting to alter perceptions of the market value of the enterprise.

In principle, outside investors should be largely indifferent to whether intangibles are expensed or capitalized. The choice of accounting treatment does not affect the underlying cash flow.<sup>6</sup> Nevertheless, there are ample indications that markets look at profits and not just cash, even if cash flow is sounder from a theoretical perspective and is the more reliable indicator.<sup>7</sup> Managers are, in turn, motivated to achieve or outdo the expected profit figures. Furthermore, studies show that managers still consider profits the most relevant figure for external reporting, in particular, the earnings per share figure. The implication is that economic decision-making is, indeed, influenced considerably by different accounting treatments.

Better information helps the capital markets to more accurately assess the value of the firm. Bad information or the absence of information allows uncertainty to persist in the minds of investors and creates information risk. When investors do not have access to information, or when they are unable to answer some key questions, they perceive a risk for which they will charge a risk premium. The result is a higher cost of capital for the enterprise. Inversely, the more transparent enterprises will have a lower cost of capital. Reducing information risk and the cost of capital is, thus, one of the primary motivations for better reporting. Economies in which there are low levels of transparency are associated with higher levels of risk and a higher cost of capital.

The dotcom fever and the subsequent burst of the dotcom bubble are often cited in this context as an example of how insufficient information can lead to distorted investment behaviour and greater risk. The dotcom companies were notorious for going to market with skimpy balance sheets. Many raised money without any performance record and some only with records of losses. They raised capital on ideas and promises. It has been argued that had better information on the intangible values that were promised, the extent of the bubble may have been smaller.<sup>8</sup> Others are sceptical that the markets would have acted differently had better information been available.<sup>9</sup> The bubble may have been driven by high levels of cash available for investment, excessive demand and speculative zeal. Despite uncertainty about how to interpret the “irrational exuberance” and the role of intangibles in the dotcom era, a lack of good information generally translates into greater risk, greater volatility and a higher cost of capital.

#### ***(a) Intangibles under the existing accounting model***

Many different terms are used in the intangibles literature to explain and describe the newfound assets that are now recognised as important sources of wealth. The terms *intangibles*, *intangible assets*, *human capital* and *intellectual capital* are the most common, and are often used interchangeably.

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<sup>6</sup> The accounting treatment (whether a company expenses money spent on, for example, training or capitalises it) is, strictly speaking, irrelevant from a cash flow perspective. Both result in cash outflows and both reduce the amount of free cash flow available to investors. By extension, both reduce the value of market equity (even if capitalisation will increase profits and the level of equity on the balance sheet).

<sup>7</sup> Richard Holway, Director, OVUM, (IT industry advisors) suggests that analysts need to adopt techniques that pay greater attention to cash flow.

<sup>8</sup> Lev, B.

<sup>9</sup> Frederick, W. (2005), from interview with Herz, B., IASB and FASB.

In normal usage (outside of traditional accounting), an asset means a useful or valuable quality, person, or thing, an advantage or a resource.<sup>10</sup> An intangible asset is thus an identifiable non-monetary asset without physical substance. Specific examples might be brand awareness (Coca-Cola or Chupa Chups), corporate image (Nike or Enron), the uncompleted research and development activities of a company (Microsoft's new Vista operating system), or the knowledge and skills that employees of a company have accumulated (McKinsey or Christian Dior). Clearly, these factors have enormous value, even if they are rarely reflected in traditional financial statements. The intangibles debate revolves around the acceptance, recognition and reporting of these values as assets and investments.

Accounting definitions, on the other hand, generally prevent the recognition of intangible assets. The reason is that the term "asset" has a very specific meaning to accountants—a meaning that is shared and understood by the financial markets. The accounting definition of assets, regardless of whether they are tangible or intangible, is more exacting and restrictive. The more limiting definition is the result of long efforts by accounting standard setters to prevent the inflation of balance sheets with fictitious assets that would disguise the true state of affairs of the enterprise.

The accounting definition of an asset according to International Financial Reporting Standards (IFRS) as promulgated by the International Accounting Standards Board (IASB) is found in the Box 1 below.

**Box 1: The accounting definition of an asset**

*Assets* are one of the five elements of financial statements. The Framework defines assets as resources an entity *controls* as a result of past events and from which *future economic benefits* are expected to flow to the entity.

*Control* relates to an entity's capacity to benefit exclusively from the benefit (or certain of the benefits) embodied in a particular asset. The entity that controls the asset can use it to provide goods and services, to settle liabilities or make distributions to owners. An entity's capacity to control an asset's benefits usually arises from legal rights, but an item may satisfy the definition of an asset even where there is no legal right.

*The future economic benefit* embodied in an asset is the potential to contribute to an entity's net cash inflow.

*Recognition of assets* is a process of recognising on the balance sheet an item that meets the definition of an asset and satisfies the recognition criteria for assets. To recognise an asset, an entity must deem it probable that *future economic benefits* associated with an asset will flow to the entity, and it has a cost or value that can be *measured reliably*.

*Reliable measurement* is the second recognition criterion. An item must possess a cost or value that an entity can measure reliably. An estimate of cost or value is usually required. Where the estimate cannot be made reliably, then the item cannot be recognised as an asset.

*Tangibility* is not an essential characteristic of an asset. International Financial Reporting Standards (IFRS) specifically define intangible assets as identifiable non-monetary assets without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Source: Based on description of International Financial Reporting Standards as described on the website of PriceWaterhouseCoopers: <http://www.pwcglobal.com/extweb/service.nsf/docid/2512b46184dcf5ae80256c480042f814>

Similar definitions can be found in the conceptual framework for accounting in most countries, certainly those who use IFRS or make reference to it in their national standards.<sup>11</sup>

<sup>10</sup> For a collection of legal, business and economic definitions of asset see: the Answers.com website at: <http://www.answers.com/asset&r=67>.

<sup>11</sup> Study On The Measurement Of Intangible Assets And Associated Reporting Practices (2003), Prepared For The Commission Of The European Communities Enterprise Directorate General.

A number of problems arise when trying to recognise new and value drivers under this characterization of assets. First, *reliable measurement* may not be possible where there is no market for the asset. Second, while *future benefits* are an implicit assumption in all expenditure decisions, it may be difficult to link a specific expenditure to a concrete outcome, much less to a specific revenue flow. A training expenditure, for example, is generally difficult to link directly to a future revenue inflow. This problem is compounded by the requirement that the company *control* the asset and by extension that the company be able to appropriate the revenue flow associated with the asset.

These requirements are difficult to meet since intangibles, in particular employee skills, are not controlled in the same way as tangible assets. Unlike a fixed asset, it is difficult for a shareholder or a creditor to assert a claim on it. A skilled employee, for example, can bring future economic benefits to the company. That same employee may under other circumstances be demotivated and withhold his full talent or co-operation. As a consequence, uncertainty is associated with the future economic benefits of intangibles and with human resources in particular. These very same uncertainties apply to physical assets; however, the perception is that they are greater with respect to intangibles.

As a result, many contributors to corporate performance are not recognised as assets and are not discussed in company reports. Some of these include items such as brands, mastheads, publishing titles, customer lists, etc. Expenditures related to creating or maintaining these assets are generally deducted from profits in the profit and loss statement even if there is little doubt that they represent a continuing value to the company.

Some intangible values, such as investments in research and development (R&D) may find their way (at least partially) into balance sheets. IFRS, for example, allows limited recognition of R&D assets if certain criteria are met. Recognition becomes more likely as a return directly attributable to a specific R&D project becomes more probable.

#### **Box 2: Accounting treatment of R&D under IFRS and US GAAP**

##### **Accounting treatment of internally generated R&D:**

Under IFRS limited capitalization of R&D is permitted if certain criteria are met. Companies can capitalize R&D expenses as the realisation of a return becomes more likely.

Under US GAAP, R&D is expensed (except for certain website development costs and certain costs associated with internal use software).

##### **Accounting treatment of externally purchased R&D:**

Under IFRS purchased in-process R&D can be recognised as a finite life intangible asset (and therefore amortised), or as part of goodwill if not separately measurable (and not amortised but subject to an annual impairment test).

Under US GAAP, purchased in-process R&D is expensed, though the US Financial Accounting Standards Board (FASB) was considering whether to move to the IASB model at the time of writing.

Source: Based upon description on Deloitte, IAS Plus website: <http://www.iasplus.com/usa/ifrsus.htm>

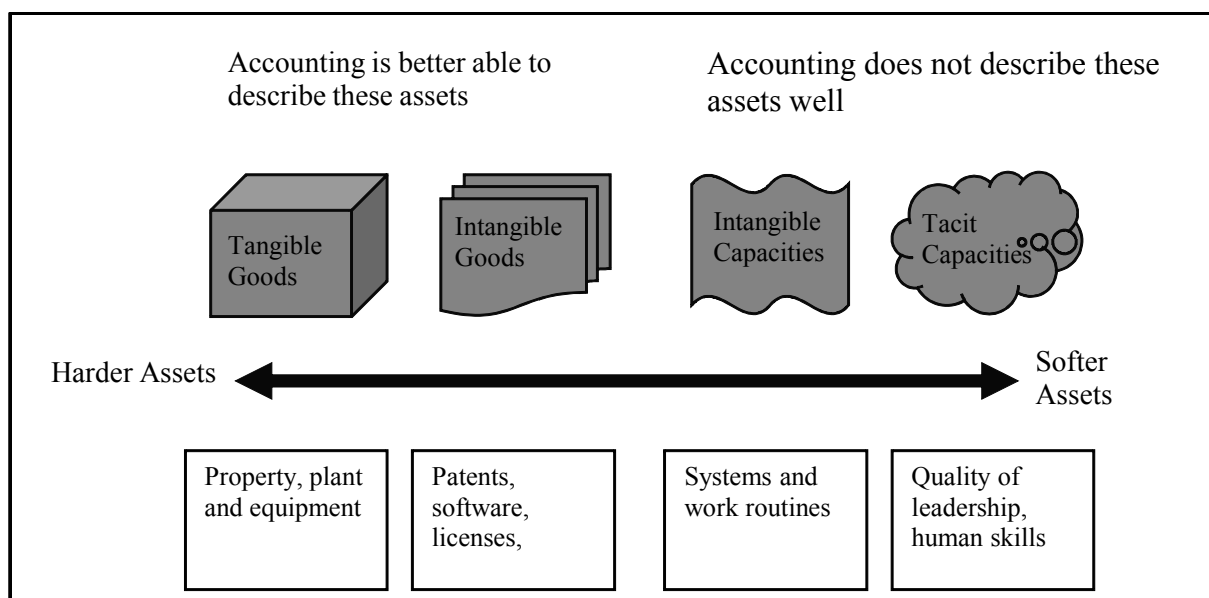
Clearly, permitting some choice can improve one's ability to portray the company. On the other hand, the fact that some companies may chose to capitalise and other companies may chose not to capitalise means that balance sheets lose some level of comparability. Increased choice and the need for judgment in assessing the probability of future returns also open the door to accounting manipulation.

Other intangible items are much more likely to be reflected in financial statements. They include computer software, patents, copyrights, motion pictures, mortgage servicing rights, licenses, import quotas, franchises and marketing rights. Human resources related intangibles, on the other hand, (skills, competence, motivation, capacity to innovate and adapt), are generally not recognised.

This leads to the observation that not all intangibles are created equal; there are different types of intangibles, each with distinct characteristics. Some intangibles are easier to measure such as software, and patents. They can exist in material form as a piece of paper, or a computer diskette. They may be separable from the enterprise, saleable and markets could exist to establish their value. Others are considerably more difficult to measure such as brand awareness. The most difficult ones to measure are arguably also the most important: the motivation and capabilities of employees, and customer satisfaction. These are both difficult to measure and may be ephemeral.

The graphic below illustrates the different nature of intangibles and provides examples of different types.

**Graphic 1: Different types of intangibles**



Source: Adaptation of diagram from PRISM website: [www.EUIntangibles.com](http://www.EUIntangibles.com)

The implication of this diagram is that different types of intangibles require different measurement and reporting techniques.

### ***(b) Financial reporting and the capital markets***

The most active users of financial statements for publicly traded companies are the capital markets (principally analysts). Analyst's valuations are, as a general rule, based upon their perception of future cash flows and not the assets (tangible or not) recorded on the balance sheet. No two analysts will likely ever arrive at the precisely the same answer. Ultimately, the final valuation of a traded company is the result of the buying and selling of market participants, and the settlement of the markets on an equilibrium price that balances supply and demand. The role of the accountant in this model is to prepare and verify the information upon which the markets will rely for their decision-making.

The analyst's valuation is an assessment of the economic benefits that arise from combining a group of physical assets with a group of intangible assets of the business as a going concern.<sup>12</sup> This assessment is always placed within the context of the risk or the likelihood that the predicted economic benefits will actually occur. The better the quality of the information that feeds into this assessment is, the better the valuation and the lower the information risk.<sup>13</sup> On the other hand, bad or insufficient information both hinder good economic decision-making and can have broad systemic consequences.

A key criticism of financial statements and, in particular, the balance sheet, is that they do not reflect the market value of the company. Numerous studies have shown large gaps between the accounting book values<sup>14</sup> of companies and market valuations. Over time, this gap has increased, and has heightened the perception that the accounting model is broken.

The work of James Tobin,<sup>15</sup> the Nobel Prize-winning economist, is often cited to support the broken accounting model argument. Tobin's-q<sup>16</sup> has been used to show large gaps between market values and accounting values. More often than not, market values are multiples of the book value of firms.<sup>17</sup> This gap has been attributed to the value of intangible assets which, according to some, need to be put on balance sheets so that they can once again properly describe the market value of companies. Tobin himself recognised problems with putting intangible information on balance sheets. Regarding human capital he said, "The problem... is that Microsoft doesn't have the smart nerds as slaves. They can be bought away from Microsoft any day—or start a new firm of their own."<sup>18</sup>

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<sup>12</sup> Going concern means that a company has the resources needed to continue to operate. If a company is not a going concern, it means it has gone bankrupt. Investopedia says, "For example, many dotcoms are no longer a going concern." Going concerns are generally valued using cash flow or similar models. Bankrupt enterprises destined for liquidation are valued using different models that are generally designed to ascertain what value can be extracted from the sale of the company's individual component assets. Going concern values are almost always higher than book values, which are generally closer to liquidation values.

<sup>13</sup> Better information does not lower the risk associated with the company's operations. It only lowers the risk associated with the quality (or lack of quality) of the information on the company.

<sup>14</sup> Generally, the total assets of the company minus current liabilities, and long-term liabilities and equity.

<sup>15</sup> American economist, known for his work on portfolio theory, which holds that diversification of interests offers the best possibility of security for investors and that investments should not always be based on highest rates of return. He also wrote on the process of information exchange between financial markets and "real" markets. He won a 1981 Nobel Prize for his analyses of financial markets and their influence on the finances of families and businesses.

<sup>16</sup> Tobin's work suggests that the proportion of the replacement value of a company's assets to market value (referred to as Tobin's-q) is an indicator of hidden assets that are unmeasured or unrecorded on the balance sheet of the company. The purpose of Tobin's work was not to illustrate this point but rather to develop an indicator of whether companies are over or under-valued by the markets: the theory being that if a company can be built from scratch, paying any more than its replacement value implies that the company is overvalued.

<sup>17</sup> Book value is generally used as a proxy for the replacement value of the company's assets, though book and replacement values are not the same. During the recent technology bubble, Tobin's Q ratio approached 3.0 for the S&P 500 (see graph at Website of Professor James Stoddard, of the Lally School of Finance & Technology at Rensselaer Polytechnic, <http://www.rh.edu/~stodder/>) and was near 2.0 in April 2005. It has not been below 1.0 since the 1980s using the Smithers and Wright method (see *Valuing Wall Street* (2000)). From <http://www.greenwichfinancial.com/wm16.htm>.

<sup>18</sup> From an interview with James Tobin while at Yale University. See: [http://cowles.econ.yale.edu/news/tobin/jt\\_96-12\\_tr\\_interview.htm](http://cowles.econ.yale.edu/news/tobin/jt_96-12_tr_interview.htm) for the full transcript.

Rather than interpreting Tobin's-q as proof that the balance sheet is broken, one can interpret it as a warning call to the whole ensemble of information used to predict market values. This covers all of the elements of a typical financial statement, including: 1) balance sheets; 2) profit and loss statements; 3) cash flow statements; 4) notes to the accounts, and; 5) management's discussion and analysis (MD&A). For listed companies, statements are often accompanied by additional filings that cover items such as executive and director remuneration, governance issues, proxy voting, notifications and more. Each of these statements (in addition to information such as press reports and information garnered in analyst's meetings) will influence a company's valuation. Analysts will use this information to estimate future cash flows and risks.

The importance of cash flow both in valuing a company and in understanding its capacity to fulfil its financial obligations are illustrated in Boxes 3 and 4 below.

**Box 3: Large assets are not equivalent to higher market value**

It is entirely possible for companies to have substantial assets and negative market value. A macro example of positive assets and negative corporate values occurred during the re-unification of the German Democratic Republic and West Germany in the early 1990s. During this period, various estimates were made of the total value of East German companies in preparation for privatisation. Estimates were originally based upon book values (total assets minus total liabilities on the balance sheet).

In February 1990, Modrow, the last communist Minister President of the former GDR, estimates the total value of East German enterprises at 1.3 trillion DM. In October 1990, Rohwedder, the first President of the German privatization agency, reduces the estimate to 600 billion DM—half the original estimate. In 1993, upon formal completion of privatization, the total cost (cash outflow) of the privatisation program exceeds total proceeds (cash inflow) from the privatization of assets by 275 billion DM. The sum total value of East German enterprise was thus negative. Why?

East German companies had significant assets before privatization. It was assumed that this meant that the companies had value. However, their cash flows were generally negative because of a rapid and forced adaptation to market conditions. The new market conditions (the need to comply with West German law, environmental and safety regulations and the government's commitment to close the wage gap between the East and West) created new costs. The result was that most companies had strong cash outflows for a number of years after re-unification. Given that valuation is determined primarily by cash flows, company values were depressed irrespective of balance sheet assets.

Privatization agency policies required that sales prices for companies be at least equal to book values. This made privatization impossible in some cases, thus forcing companies into liquidation. Cash flow valuation was a politically sensitive issue since it revealed that the patrimony of East German workers in the context of a market economy was nil or negative.

Source: Based on Vehse, Wolfgang (1994), Privatization German Style: A Look Inside the Practices and Policies of the Treuhandanstalt, Presentation at NATO Colloquium.

An example of the importance of cash flow and how profits can provide a false picture of the company's health is provided in Box 4 below.

**Box 4: “Cash is King”: profitable companies can be bankrupt companies**

A profitable company can be insolvent under the “matching principle”, an accounting convention.

The matching principle is an extension of the revenue recognition convention. The matching principle states that each expense item related to revenue must be recorded in the same accounting period as the revenue it helped to earn. If this is not done, financial statements will not show the results of operations correctly.

Under this principle a profitable, seemingly healthy, company can be insolvent and become a candidate for liquidation. This occurs when, for example, the recognition of expenses on an investment project are postponed until there are associated revenues against which to match the expenses. The result can be that profits do not reflect the expenditure, even if cash flows are negative. A company may, as a consequence, show significant profits, have significant assets, and simultaneously be insolvent.

Another example might be a company with large accounts receivable. The balance sheet might give the appearance that the company is increasing equity, but the company can still be short on cash with which to pay wages or make purchases.

The expression “cash is king” is sometimes used in business to refer to the importance of cash flow in assessing the financial strength of a business.

Ultimately, a company’s obligations—unless we are operating in a barter economy—can only be paid with cash. Cash flow is also the ultimate basis for valuation—not assets—even if analysts and other users of financial statements may look closely at assets and other indicators such as profits and price earnings ratios. Cash flow is also important because profits are subject to manipulation and misinterpretation. Cash, on the other hand, is not open to the same interpretation as profits; a company either receives cash or uses cash. It is relatively easy to track and is as close to fact as one can get in the financial world.

It is fair to say that valuation is part art and part science. It results in estimates of the price that informed buyers and sellers would negotiate at arms length for an entire business or a partial equity interest in the form of shares. Valuation includes considerable guess-work about the size of cash flows and the probability that they will occur. Another observation is that valuation is forward-looking, whereas financial statements are backward-looking. Valuations are, consequently, marked by all of the uncertainties of prediction. As a result, valuations vary, sometimes quite considerably. In addition, they are strongly influenced by circumstances external to the company, circumstances that are, more often than not, out of the control of management and outside of the ability of the accountant to record.

Finally, not all capital markets users will use financial statements to produce valuations. Lenders (who, in most countries, form a much larger part of the capital markets than equity investors) will use financial statements differently. They are less interested in equity prices than the ability of the company to repay principle and interest on loans. Cash flow is even more important to lenders than investors since equity investors can simply sell their shares in a company if they find its prospects dubious. Lenders cannot extract themselves so easily from a relationship with a borrower.

***(c) The role of non-financial reporting***

Financial reporting is traditionally accompanied and complemented by non-financial information. Non-financial information helps users understand the numbers and may convey important information in its own right. It can take the form of special filings required by stock exchanges and securities commissions and can go far beyond the financial statements in terms of the information it covers. Some of the information that publicly traded companies can be expected to disclose includes descriptions of key executives, discussions of risks—especially when a company is first being floated—information on executive remuneration, board composition, governance policies, key personnel, etc. These non-financials items are typically part of formal reporting requirements.

Formal reporting may also be supplemented by informal information. One of the most common sources of informal information is through meetings with executives. Private meetings allow analysts to see the company through the eyes of executives. Meetings can provide information on firm strategy, product development, the likelihood of future events, risks, the results of R&D, the likelihood of regulatory approval for a new drug, etc. Meetings with executives also allow for the testing of management's ideas in a manner that cannot be done with a written report. They also allow analysts to assess the quality of management, a factor which is broadly agreed as being of key importance in understanding a company's prospects. This information may be communicated verbally and convey information on intangible aspects of the enterprise.

Even though the information may not be "material" according to an accounting definition, what is communicated in meetings and phone calls has real information value. The type of information analysts get is typically qualitative and future-looking, which is precisely what is needed for their valuation models. Some of it is highly subjective, for example, the impression of competence that a CEO conveys. This kind of non-financial information is often aggressively sought out.<sup>19, 20</sup> On the other hand, there is scant evidence that analysts have a particular interest in human capital indicators such as, for example, training expenditures. Nevertheless, the quality of management—a key human capital indicator—consistently ranks high in studies of what factors analysts consider important for investment decisions.<sup>21</sup>

While non-financial reporting is not new, many new types of reporting are emerging that seek to address the interests of users in non-financial aspects of enterprise performance. One specific area in which there has been a surge in interest is corporate governance disclosure. Some years ago, governance was considered an arcane field reserved for corporate lawyers and academics. Since the Asian crisis of 1997 and the passage of the OECD Principles for Corporate Governance in 1999, international demand for greater governance disclosure grew dramatically. Since then a new industry revolving around the production and analysis of governance-related information has emerged. This new industry is composed of proxy and share voting advisors, governance ratings companies, governance stock indices, and governance investment funds among others. Good governance—arguably a key intangible value of an enterprise—is now subject to a level of disclosure and examination that was scarcely conceivable before.

#### ***(d) Social reporting versus human capital reporting***

Non-financial reporting can serve multiple purposes. For example, human capital reporting may describe the process of how humans interact with other factors to innovate, produce and ultimately create value and profit. Human capital reporting may also be driven by the goal of creating greater awareness of the importance of human versus financial capital. It can emanate from the desire to value and assign importance to human inputs as much as to financial inputs, and to see human resources treated fairly and ethically. These differing objectives lead to different types of reporting.

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<sup>19</sup> Lev, B. from intervention at Ferrara intangibles Symposium October 2005.

<sup>20</sup> Even if the information communicated during analysts meetings on intangibles has value, it may not be used in any formal systematic fashion. It has been argued that more formal training of analysts is required to find and use this information. Thomas, A. Presentation at Ferrara intangibles symposium, October 2005.

<sup>21</sup> An important policy concern is that information conveyed in analysts meetings may not be equally available to the investing public. If information is only available to a small group of investors with privileged access, then a situation may occur that is unfair to retail investors. Holland considers that privileged access to information may be necessary to provide incentives for institutional investors to conduct research and exercise a governance and oversight function. On the other hand, Regulation Fair Disclosure (FD) in the US seeks to regulate the question of "selective disclosure" to a particular group of investors and stipulates that information must be disclosed fairly. Regulation FD is discussed below.

Socially-driven reporting is important because people are important. Socially-driven reporting seeks to assign a more important role to people in a reporting process that gives little importance to human factors. Accounting definitions require the expensing of most human related expenditures, whereas other types of expenditures are treated as investments that ostensibly yield a more enduring return over time. Accounting therefore seems to value human contributions less than physical capital. The implication is that human capital is not important, is not actively managed and is, at worst, a resource to be consumed.

Market-driven human capital reporting seeks to integrate the human factor into the production and reporting model. It recognises that knowledge and innovation are characteristics of humans and not financial capital. It ascribes productivity, efficiency and competitive advantage to humans and not physical assets. In this model, humans and knowledge are important drivers of the corporate machine. They not only influence but may actually determine the performance of the company. It is thus argued that their role needs to be better understood, better documented and better reported. Better understanding should, in turn, improve company performance and improve the efficiency of capital markets.

It is useful to distinguish between these two different types of reporting. Socially-driven reporting will include a different set of measures than market-driven reporting. It might include racial balance, gender balance, information on the promotion of females in the workforce, paternity leave policy, child labour practices and other factors that may not be directly linked to corporate performance.<sup>22</sup> The standard against which performance is measured may be a legal standard (labour laws for example) or an unwritten social norm. Market-based human capital reporting focuses on a narrower set of indicators that reveal the impact of human capital on the value creation process and, ultimately, on profits.

From the perspective of the capital markets, social information has been greeted with caution. Nevertheless, interest from the financial markets in CSR reporting has grown as the result of the view that a company's social and environmental policies, and actions do have an impact on financial performance. This view holds that companies that act responsibly perform better<sup>23</sup> and that breaking norms and the spirit of the law (even if not the letter of the law) imply risks and costs for the company. Some corporate policies, such as the outsourcing of production to countries with weaker child labour have resulted in public outcries and consumer backlashes that have demonstrated the effect of corporate social policies on earnings. Adverse public sentiment can cause considerable and long-lasting damage to the image and brands of companies, and ultimately reduce earnings potential. Some new investment funds invest based purely on a desire to see ethical outcomes, while others track environmental and social indicators to glean information on hidden risks.<sup>24</sup>

An important aspect of CSR reporting is that it is mostly voluntary and that there is no generally accepted approach to compiling and presenting the data. In the absence of internationally agreed CSR standards and a conceptual framework, CSR and other qualitative communications are subject to interpretation and manipulation. Some information may, in fact, be hard to distinguish from advertising. In the worst cases, it can be used to mislead the public and investors. This problem applies to some extent to intangible reporting as well. Unlike accounting frameworks that require both positive and negative views be represented fairly, there are no such constraints on CSR communications.

This weakness in CSR reporting has led to calls for an internationally recognised conceptual framework for reporting. There have been numerous efforts to create standards in order to give users

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<sup>22</sup> Lev, B.

<sup>23</sup> See OECD Principles of Corporate Governance.

<sup>24</sup> See website of Enhanced Analytics, a grouping devoted to pursuit of the use of broader indicators in stock analysis: <http://www.enhancedanalytics.com/>.

greater confidence in social reporting. The Global Reporting Initiative (GRI) is, arguably, the initiative that is best known for its work. On an international level, the OECD Guidelines on Multinational Enterprises provide an internationally agreed framework for socially responsible behaviour for multinationals and include a section on good disclosure practices. A large number of other pronouncements exist that are designed to guide both preparers and users of CSR reports<sup>25</sup> though none has become broadly accepted on an international level.

While there are commonalities between socially-driven and market-driven reporting, intangibles reporting is not the same as corporate social responsibility reporting.<sup>26</sup> Socially-driven reporting is less concerned with corporate performance, and more concerned with ethical behaviour and the long-term sustainability of businesses. It is legitimate in its own right. Market-driven human capital reporting may have a social component and may overlap to some extent with CSR reporting though it is focused on describing how enterprises create value. It may, as a consequence, have greater implications for market regulators. In any event, it is important that the “who and why” of reporting be clearly articulated for both human capital and social reporting and that the intended users are clearly identified since they will ultimately determine the choice of measurement criteria and reporting techniques.

***(e) The politics of intangibles***

The interaction of various constituencies, each with an interest in reporting, has been referred to as the “politics of intangibles”.<sup>27</sup> Companies, the accounting profession, accounting standard setters, government and other stakeholders all have different and sometimes conflicting interests and views on the intangibles question. Since many of a company’s most valuable intangible assets are associated with its stakeholders, business partners, employees, customers, suppliers and local communities, intangibles reporting is often perceived as satisfying the needs of special interest groups.

Some of the pressure on accounting statements results from the fact that they do not satisfy the needs of a broad group of users. Most accounting frameworks state that financial statements are intended to be general purpose. In practice, some stakeholders are served much better by the current reporting model than others. Financial users are served best, with those interested in social, environmental and human issues, and all manner of intangibles being served considerably less well. Increasingly other users find that traditional financial statements do not tell them what they need to know.

The intangibles debate is also politicised because the new forms of reporting demanded today suggest new corporate values and objectives. For example, the goal of environmental and corporate social responsibility reporting is to influence company policy by exposing companies to public examination. Michael Malone, an intellectual capital journalist, articulates the capacity of intellectual capital disclosure to influence companies on non-financial issues:

*[Intellectual capital is] not merely a new model for valuation, but a new arbiter of value... intellectual capital renders a moral judgment on what is good and proper behaviour. In doing so, intellectual capital establishes a whole new set of images through which to order the world, and*

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<sup>25</sup> See, for example, AccountAbility, ISO standards, the Sullivan Principles, the UN Global Compact, etc.

<sup>26</sup> The EU Study On The Measurement Of Intangible Assets And Associated Reporting Practices suggests that different types of reporting (financial, social and environmental) could eventually be combined into a “unified sustainability report”. So-called triple bottom line reporting (financial, social and environmental) is practiced by some companies, but no model exists that allows the three to be unified conceptually.

<sup>27</sup> See Lev, B. (2001), *Intangibles: Management, Measurement, and Reporting*, The Brookings Institution.

*to determine what behaviour will be valued and rewarded and what will be dismissed and punished.*

Malone describes the capacity of reporting to be used as a moral arbiter. This normative aspect is welcomed by some, but troublesome to others who question rules that are not democratically agreed, or who feel that intellectual capital reporting should not be used to “control” the behaviour of firms.

Companies often feel that the only standard by which they should be judged is their ability to generate returns to owners. Though support for Milton Friedman’s<sup>28</sup> views tends to be more nuanced today, there is broad agreement that companies must have a “pole star”, a single performance objective to guide corporate actions, against which performance can be measured.<sup>29</sup> The alternative is conflicting and confusing goals that pull managers in different directions and ultimately result in inefficiencies.<sup>30</sup>

In the end, all reporting is contentious because it has the power to set the agenda and to control. The power to demand information is also the power to demand accountability. As a consequence, all reporting has a normative aspect. It is not the mere provision of data; it provides a standard against which actions are measured and assessed, and the process of assessment inevitably implies changes in actions and behaviour.

Policy makers may support the development of greater intangible assets and more intangibles reporting for different reasons. Some see intangible assets as a tool to reduce the undesired effects of globalisation and greater competition. Others see it as a source of innovation. Others still wish to promote a new governance model or protect their companies from takeovers.<sup>31</sup> For some, this use of intangibles reporting suggests a return to industrial policy and threatens to unwind some of the changes brought about by market liberalisation, privatisation and de-regulation.

Malone recognises the potential pitfalls of intangibles reporting:

*There are some good reasons for not attempting to measure the intangible assets, the intellectual capital, of companies and other organizations. Such a measurement will be difficult, imprecise, and it will open the Pandora’s Box of politicization and hype, fad and fraud.*<sup>32</sup>

He goes on to argue that an attempt must nevertheless be made to describe intangibles.

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<sup>28</sup> American economist who won a 1976 Nobel Prize for his theories of monetary control and non-intervention of government in the economy. Friedman defended free enterprise and attacked government regulation. He condemned socialism and lauded capitalism for combining prosperity with personal liberty.

<sup>29</sup> The importance of the “pole star” was underscored by Ira Millstein, Weil, Gotschal & Manges, LLP, Head of the Business Sector Advisory Group to the OECD in the context of the deliberations leading to the drafting of the OECD Principles of Corporate Governance.

<sup>30</sup> Despite the attempts of governments over the past 20 years to move the state out of the private sector, companies continue to be seen as the solution to many social problems. Globally, there has been a trend for governments to relinquish direct control of companies and abandon industrial policy in favour of more market driven approaches. Paradoxically though, some governments rely increasingly on business not only provide for business models for providing social services but as providers of certain social functions.

<sup>31</sup> The Interim Report (2005) of the Subcommittee on Management & Intellectual Assets, New Growth Policy Committee, Industrial Structure Council.

<sup>32</sup> Michael S. Malone (1999), Quantifying the Brave New World, Hoover Digest, 1999 No. 1.

In summary, there are a number of reasons why the intangibles debate is politicised. For one, financial transparency objectives are often co-mingled with social objectives. Furthermore, requiring reporting is equivalent to requiring accountability. The difficult issues may, thus, be political as much as technical.<sup>33</sup>

## 2) Views on solving the intangibles reporting problem

There are different views on the solution to the intangibles reporting problem. This section presents three schematic approaches that reflect some of the broad lines of thinking on the matter:

- 1) *Fundamental overhaul: rethinking the accounting treatment of intangibles:* This view holds that fundamental change to the accounting system is needed to address its shortcomings. Financial statements do not reflect what drives value today. As a result, intangibles need to be put on balance sheets to allow statements to meet the needs of the capital markets and new users. This view puts both the problem and the solution in the camp of traditional financial reporting, specifically, accounting.
- 2) *Disclosure of greater detail in the existing reporting framework:* Another view says accounting need not be altered fundamentally, though new information needs to be provided. This new information can appear in traditional financial statements as footnotes or addenda, or in Management's Discussion and Analysis (MD&A) or equivalent. New disclosures would have to adhere to the rules of accounting and reporting. This is a solution within the traditional financial statements and is aimed at traditional users.
- 3) *Supplemental reporting outside of the existing accounting framework:* Fundamental change to traditional financial reporting is neither feasible, necessary nor desirable. It is not desirable because the existing system of accounting and financial reporting will not yield the information that is required, nor feasible because barriers prevent change to the accounting system and because the existing system works; it provides a certain group of users with adequate—if not perfect—information on what they need. As a result, an entirely new form of reporting is needed that is designed specifically for the needs of new users and is separate from traditional accounts.

In practice, all three approaches are being pursued to varying degrees. Some significant changes are occurring in the accounting field in the treatment of certain intangibles. Some additional information is being provided in financial statements in the form of disclosures and, at the same time, new forms of supplementary reporting are emerging. Most of the reporting initiatives described later in this report fall into the second or third category. Those initiatives requiring MD&A disclosure would fall under the second grouping, while those that propose new freestanding reports would fall under the third. New forms of reporting are particularly promising in the human capital area where traditional accounting has had the greatest difficulty. These approaches are presented in somewhat more detail below.

### ***(a) Fundamental overhaul: rethinking the accounting treatment of intangibles***

Proposals for fundamental overhaul are predicated on the perception that the existing accounting model is broken. This view found greater resonance some years ago. A completely new approach to accounting was proposed that would allow the capitalisation of a great number of expenditures that could

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<sup>33</sup> The political nature of reporting applies not only to intangibles but to financial and non-financial reporting as well. Politicised issues in financial reporting are stock option accounting and business combinations. Stock options (considered an irreplaceable tool for motivating executives by some) are a source of unjust, unaccounted, and unmerited enrichment for others. Business combinations accounting directly influence takeover markets and the ability of companies to acquire other companies. Remuneration and governance disclosure are contentious in the non-financial reporting arena.

be considered investments such as training and even a portion of remuneration. The promise was to alter management and market behaviour to address some of the shortcomings noted in previously in this report.

The limits to change were set by the conceptual framework of accounting, which contains criteria that determine what can be recognised as an asset or not and, consequently, what can be capitalised. While conceptual frameworks differ from country to country they are consistent in the substance of what defines an asset. The rules say that in order for an asset to be recognized, it needs to pass certain tests, which are summarised in Box 1 above. Assets have to be controllable, have a verifiable associated future benefit, be identifiable, be measurable, and so on. These hurdles are difficult for most intangibles to cross.

The difficulties associated with capitalising intangibles were initially blamed on the rigidity of the conceptual framework and on the intransigence of accounting standard setters. What was not, perhaps, immediately apparent was that the conceptual framework for accounting is the result of many years of experience and consideration. Change to the framework tends to be slow because of its “constitutional” nature and because of a due process in which many views are considered and reconciled. The strength of the framework is that the resulting standards and rules provide a broadly understood and accepted language for financial communications. Whilst some criticised the framework for being faulty, others argued that the framework was sound and that it was correct for standard setters to reject the inclusion of a broad set of intangibles into the balance sheet as assets. The exclusion was not a technical matter but rather the result of considered reflection and choice.<sup>34</sup>

This choice reflected, among other things, the risks associated with capitalisation. The views of analysts, a major group of users, illustrate this risk:

*“... Readers... will remember my campaign... to outlaw the capitalisation of development expenditure. In 1995, many quoted... software companies artificially inflated their reported profits by putting this expenditure on the balance sheet. It made any meaningful comparison of performance almost impossible. QSP and Coda were in the same market. QSP reported profits for years merely because they capitalised development costs. At the headline level QSP looked healthy compared with Coda (which expensed such costs as incurred). Only after repeated badgering... did QSP finally divulge how much they were capitalising, which showed... that they had been loss-making for years. Soon afterwards they went into receivership. Fortunately, very few software companies now capitalise development.”*

Richard Holway, Director, OVUM, (IT industry advisors)

Capitalisation can make comparability difficult and can be used to hide the true state of a company’s affairs. In this example, an examination of a company’s cash flow should have revealed a problem. Cash is the only factually verifiable item in the accounts. It is not subject to manipulation nor open to interpretation and judgment. However, not all investors or analysts devote the attention to cash flow that they might. Holway cites this as a reason to wean investors away from their focus on profits and to make them pay closer attention to cash.

The consensus has emerged that the accounting model, even if imperfect, does provide value and even its most acute critics propose conserving its core aspects. Baruch Lev, for example, has proposed dual track reporting with “core” information that corresponds to existing reporting and supplemental information provided under a different reporting framework that does not require the same standards of verifiability as accounting statements. Under this scheme, certain intangibles information would be included in satellite statements. This view acknowledges that the existing accounting model has strengths worth preserving.

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<sup>34</sup> Upton Jr., W. FASB.

Even if accounting is not fundamentally broken, considerable changes are being made to the model. Accounting has recently undergone an important shift from historical to fair market value reporting. Historical reporting was valued because it provided some level of certainty and verifiability for the numbers; a receipt could generally be used to document the existence of a transaction. Historical accounting intended to encourage objectivity but, in practice, could result in extreme distortions. In a simple example, real estate prices might increase over time while being reflected at nominal cost on the balance sheet, thus distorting the true picture of the enterprise.

There have also been efforts within the accounting community to address the special issues that intangibles raise. One of the first was sponsored by the American Institute of Certified Public Accountants (AICPA) and resulted in a report by the so-called Jenkins Committee.<sup>35</sup> The committee, which issued its report in 1994, formulated a number of proposals which included: 1) disclosure of more forward-looking information such as business plans, opportunities, risks and uncertainties; 2) more emphasis on the factors that lead to long-term value, including non-financial measures that indicate how the important business processes are functioning, and; 3) a closer connection between the information used internally for management of the company and the information that is publicly released. These recommendations have been addressed to varying degrees in ensuing years but remain relevant today.

The US Financial Accounting Standards Board (FASB) followed with a project of its own in 2000.<sup>36</sup> It decided to conduct a research project on business reporting, established a steering committee and began investigating methods for voluntary disclosure of information that could be useful for making investment decisions. In 2001, the report of the steering committee, which included a spirited defence of the existing accounting framework, was completed. The report proposed the following five reporting requirements:

1. Identify the critical success factors of the company's business;
2. Identify management strategies and plans for managing critical success factors;
3. Identify metrics used by management to measure and manage the implementation of strategies and plans;
4. Consider whether the expected benefits from voluntary disclosure are greater than the potential adverse effects on the competitive position of the company, and;
5. If disclosure is deemed appropriate, determine the best way to present the information.

The steering committee also proposed further work on intangibles reporting within FASB, in particular, to resolve questions regarding the different accounting treatments of internally generated versus externally acquired intangibles. This proposal was, however, put on hold as result of Enron and other reporting scandals, which resulted in less interest in intangibles reporting and considerably more interest in the credibility of the entire financial reporting system. By 2004, the AICPA once again took the lead with the establishment of its Enhanced Business Reporting Consortium (See below) which was to promote a discussion of improved business reporting.

Clearly, significant challenges remain in the accounting of intangibles. Perhaps the most serious is that an intangible that a company buys can be recognised as an asset because a transaction occurred, while that

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<sup>35</sup> American Institute of Certified Public Accountants (AICPA), Special Committee on Financial Reporting (Jenkins Committee), *Improving Business Reporting—A Customer Focus: Meeting the Information Needs of Investors and Creditors*, (1994).

<sup>36</sup> Upton Jr., W, FASB (add reference).

very same intangible, if it is created by the company, cannot generally be recognised as an asset (See Box 2, above). This inconsistency illustrates tensions within the accounting framework that occur because accounting is based on recording and reporting discrete, transaction-based events like sales, purchases, cash receipts and disbursements. The ability to observe and record contributes to the reliability of statements. However, if there is no transaction, as is the case with internally generated intangibles, the accountant is forced to make assumptions that threaten the reliability of the accounts.

In summary, accounting is changing. It is not static, as some might suggest, though there are many outstanding issues that remain to be resolved. One of these is how to report internally generated intangibles. Nevertheless, proposals for radical change and the large scale capitalisation of a broad number of intangible values are not widely supported, and have diminished over time. Radical change in the form of capitalisation can introduce subjectivity and risk into statements. The recent spate of corporate reporting scandals in which companies pushed accounting standards to their extreme has temporarily militated against the introduction of greater choice in statements. Irrespective of whether intangible assets find their way onto the balance sheet, accounting alone does not describe how value is created. This challenge remains to be addressed. There is a view that the question will need to be answered in the overall reporting model, not just in the balance sheet.<sup>37</sup>

***(b) Disclosure of greater detail in the existing reporting framework***

The above section talks about the potential for the “recognition” of intangible assets in the financial statements. Recognition means that information must be reported in a quantitative form in the balance sheet or the P&L statement. Discussions of recognition often include discussions of the alternative which is referred to as “disclosure”. Disclosure means that information can be provided in either quantitative or qualitative form in the notes to the accounts.<sup>38</sup> Disclosure has been proposed as an alternative to recognition because it does not require the extensive changes to the accounting model that recognition would imply.

In 2001, the Brookings Institution assembled a task force, which was to reflect on the intangibles problem and propose solutions.<sup>39</sup> One of the conclusions that resulted from the deliberations was that the location of intangibles information in the financial reports was less important than the presence of such information. It found that it might not be necessary to change accounting standards or the accounting culture if supplemental disclosure were allowed. Supplemental disclosure could occur in the footnotes to the statements, in special places such as safe harbours, or elsewhere.

Some regulators also support the notion that companies should be obliged to give out supplemental information. Lynn Turner, former chief accountant at the US Securities and Exchange Commission (SEC), and now at the University of Colorado says “There should be new sections in annual reports on companies' intangible assets and on “key performance indicators”—such as employee turnover, customer acquisition cost or inventory turnover.” Turner goes on to say that the single most important thing that regulators could do to improve accounts would be to make companies report audited key performance indicators. Proper insight into a company's business, he adds, can “highlight accounting shenanigans.”<sup>40</sup>

<sup>37</sup> Eccles, Herz, Keegan, the Value Reporting Revolution.

<sup>38</sup> Study On The Measurement Of Intangible Assets And Associated Reporting Practices (2003), Prepared For The Commission Of The European Communities Enterprise Directorate General.

<sup>39</sup> Brookings Institution, 2001, Unseen Wealth: Report of the Brookings Task Force on Intangibles, see: <http://brookings.nap.edu/books/0815701136/html/index.html>.

<sup>40</sup> Kenan Patrick Jarboe, April 2005, Reporting Intangibles, A Hard Look at Improving Business Information in the U.S., Athena Alliance.

At the SEC, the provision of supplemental and interpretive information is generally placed in the context of MD&A (Management's Discussion & Analysis) disclosure. In the relevant SEC Interpretation Guidance it is suggested that "companies should identify and discuss key performance indicators, including non-financial performance indicators that their management uses to manage the business and that would be material to investors".<sup>41</sup> Harvey Goldschmid, a commissioner at the SEC, adds that the SEC will consider how to get companies to publish key performance indicators "as soon as we realistically can".<sup>42</sup>

Since 1980, the SEC has required the MD&A to provide explanatory information necessary to understand the financial situation of the company, changes in financial situation and business results. The purpose of this requirement is to ensure that business operators disclose the impact of any known trends or relevant business circumstances on future business results, and to raise the awareness among investors that the current financial statements do not necessarily indicate future business results. The MD&A requirement has been revised on a number of occasions since then.

Another means of getting more information into financial statements is to disaggregate existing line items. For example, SG&A (Sales, General and Administrative) expenses, which typically include everything from pencil sharpeners to salaries, can be disaggregated to show training expenditures. Training and other expenditures on intangible items could thus be disclosed without changing the accounting model. This type of disaggregation would be very welcome by analysts who "consistently requested that financial statement data be disaggregated to a much greater degree in order to predict the overall amounts, timing or risks of a complete enterprise's future cash flows".<sup>43</sup>

In principle, there is nothing that impedes companies from disaggregating. Accounting provides the option for companies to do so, even if it is common practice to provide simple statements without extensive breakdowns. A key challenge is determining the limits of disaggregation. Arguments for disaggregation can be made for a large number of items. The FASB specifically considers the costs and benefits of disaggregated disclosures, noting that too much detail "may not be useful to readers of external financial statements and it also may be cumbersome for an enterprise to present."<sup>44</sup> Taken to an extreme, disaggregation may increase disclosure without an increase in information value

In summary, additional disclosure could allow greater information on intangibles to be provided within the existing reporting model. Similarly, disaggregating data such as training expenditures could be done without altering the conceptual framework for accounting. Disaggregated data can be required by market regulators and can be provided voluntarily by companies<sup>45</sup>. Additional reflection is required to understand what kinds of items could be disaggregated and what the logical limits of disaggregation might be.

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<sup>41</sup> US Securities and Exchange Commission, Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, 17 CFR Parts 211, 231 and 241, [Release Nos. 33-8350; 34-48960; FR-72].

<sup>42</sup> Kenan Patrick Jarboe, April 2005, Reporting Intangibles, A Hard Look at Improving Business Information in the U.S., Athena Alliance.

<sup>43</sup> Arthur Andersen LLP, 2000, Commentary Letter to US SEC, Re: File No. S7-03-00 (Release Nos. 33-7793; 34-42354), Supplementary Financial Information.

<sup>44</sup> Arthur Andersen LLP, 2000, Commentary Letter to US SEC, Re: File No. S7-03-00 (Release Nos. 33-7793; 34-42354), Supplementary Financial Information.

<sup>45</sup> Herz, B., President IASB and FASB.

***(c) Supplemental reporting outside of the existing accounting framework***

This section of the report makes some observations regarding new reporting from a general perspective while the details of some new reporting models are described in below.

Most of the recent developments in intangibles reporting are occurring outside of the existing reporting model. New specialised forms of reporting are emerging with some frequency. These models approach reporting not from the perspective of what can be forced into an existing system of reporting, but what is of interest to potential users. Most are still in early stages of development and require further testing.

Some of the new reporting is very numbers oriented, perhaps as a result of an extension of the thinking that “you manage what you measure”. The objective is, of course, to make intangibles values measurable, verifiable and ultimately comparable. Capital market users tend to prefer hard data, even if they all agree that valuation is ultimately subjective.<sup>46</sup>

But, not everything that can be measured is of any particular value. It is not certain how some of the numerical indicators emerging as part of new reporting techniques should be interpreted. For example, the presence of a very large number of computers in a company can be interpreted as a sign of a computer savvy workforce—or loose procurement procedures. The level of education of employees may be sign of great competence—but an overly-educated staff doing tasks that are below their level of training can be frustrated and demotivated.

New forms of reporting hold great potential, and we are currently experiencing an enormously creative period. They have the prospective of tailoring information to the specific needs of users and providing new and important insights into business. They can address the concerns of new corporate constituencies, while at the same time offering important information to traditional users.

\* \* \* \* \*

The three alternatives presented in this part of the report are a schematic of the main views on resolving the intangibles problem. Some of the public and private initiatives discussed hereafter can be grouped into the schematic in the following manner:

**a) Fundamental overhaul: rethinking the accounting treatment of intangibles**

- There are no projects underway to fundamentally recast accounting in order to take account all intangible assets
- There is ongoing work by standard setters including IASB and FASB to recognise intangibles, in particular, in the context of accounting standards for business combinations and intangibles

**b) Disclosure of greater detail in the existing reporting framework**

- The Jenkins Committee Report
- US SEC Guidance on MD&As

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AIMR/AICPA.

- The EU Accounts Modernisation Directive
- German Accounting Standard 15
- The Operating and Financial Review in the UK

### **c) Supplemental reporting outside of the existing accounting framework**

- MERITUM
- Danish Agency for Trade and Industry
- Wissensbilanz in Germany
- Guidelines for Disclosure of Intellectual Assets in Japan
- The Institute for Employment Studies in the UK

Proposals for wholesale change have gradually ceded to more cautious approaches that include disaggregation and supplemental reporting. Other approaches have been proposed. One of the more innovative proposes the creation of markets for intangibles.<sup>47</sup> Intangibles, under this view, are not an accounting problem but a valuation problem. The solution, in turn, lies in real and options markets that would be used to value intangibles. This may work for intangibles such as brand names, patents and others items which lend themselves to valuation. In fact, markets for these items already exist. Markets may eventually succeed in attaching a number to human capital. They are, however, unlikely to address the detailed information needs of those interested in human capital management and human capital reporting.

Time has resulted in more pragmatic responses. Accounting standard setters are responding, while entirely new reporting models are emerging. These new models address the needs of both traditional and new users, and may provide both financial and socially relevant information. The new reporting does not, however, obviate the need for improving the accounting model. Changes within the existing accounting framework are real but will not address all intangibles. Gaps can be expected, particularly in the area of human capital. This suggests that human capital is an area where new reporting models hold particular promise.

### **3) Selected policy responses**

Intellectual capital reporting is largely unregulated, which can be to the great benefit of companies seeking to tailor their message precisely to the nature of their enterprise. It can also be to the detriment of users who make seek comparability, completeness, a balance of good news and bad news, and verifiability. Comparability, completeness, balance and verifiability are features of a more structured system of reporting in which there is usually an oversight of self-regulatory and/or regulatory body.

This section of the report presents some of the areas in which governments have contributed rules and structure to the communication of non-financial data or on intangible assets. The reporting of certain non-financial information is, of course, highly regulated in most developed financial markets. The type of policy responses that are discussed here are those which may have a direct or indirect relevance to the reporting of the type of intangible assets which are the focus of this report. A number of different examples of policy responses are discussed: some policies aim at creating a “level playing field” by providing equal and fair access to information; “safe harbours” are intended to encourage good faith corporate communications by protecting companies and executives from frivolous lawsuits, and; pronouncements which encourage greater reporting in the context of Management’s Discussion and Analysis (MD&A) in the US and director’s reports in the EU.

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<sup>47</sup> Leadbetter, C., Measures for a New Economy, Centre for Business Performance, ICAEW.

***(a) US SEC Guidance Regarding Management's Discussion and Analysis***

In 2003, the US Securities and Exchange Commission (US SEC) published its Interpretation Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations.<sup>48</sup> The interpretation is intended to elicit more meaningful disclosure in the MD&A in a number of areas, including: 1) the overall presentation and focus of the MD&A; 2) a general discussion and analysis of known trends, demands, commitments, events and uncertainties, and; 3) more specific guidance on liquidity, capital resources and critical accounting estimates.

Financial measures are generally the starting point in forming a picture of the enterprise. With this interpretation guidance, the SEC seeks to elevate qualitative discussion and non-financial measures to a higher level. The interpretation encourages companies, when preparing an MD&A, to consider disclosure of additional factors that might be material to investors. These factors may be non-financial.

Companies are required to consider disclosing certain intangibles information that may be peripheral to the accounting function, but are integral to the business such as the status of product development, service offerings, affiliations/joint undertakings, customer/vendor relations, business strategy, changes in the managerial approach or structure, etc. The annotations to the interpretation note that, depending on the circumstances of a particular company, these factors could include human resource issues such as employee turnover rates.

Companies are also enjoined to evaluate the quantity and usefulness of the information they disclose with a view to avoiding unnecessary information and “information overload” for investors. Much leeway is given in deciding what is appropriate and cost effective. The interpretation recommends caution with respect to disclosure of information that is not required, is immaterial, or does not promote a better understanding of the business.

***(b) Regulation Fair Disclosure in the US***

When the US SEC's Regulation Fair Disclosure or “Regulation FD” became effective in October 2000, it was hailed as a piece of landmark regulation. The regulation is designed to eliminate “selective disclosure” by creating equal access to material disclosures occurring during discussions between management and analysts, thus levelling the playing field between investors who have direct access to management and those who do not. Specifically, it stipulates that material information disclosed to analysts or other members of the investment community during analysts meetings must be made available simultaneously to the investing public.<sup>49</sup>

Prior to Regulation FD, US securities law did not generally require issuers to make public all material developments as they occurred. As a result, companies could control who received the information that was used to determine stock prices. For example, before Regulation FD, if a disclosure was made at a time when no SEC filing was required, the issuer could determine to whom and how to make its initial disclosure. This allowed issuers to selectively disclose information to favoured analysts or institutional investors prior to making a broad public disclosure via press release or an SEC filing.

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<sup>48</sup> Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations Securities and Exchange Commission 17 CFR Parts 211, 231 and 241 [Release Nos. 33-8350; 34-48960; FR-72].  
See: [http://www.sec.gov/rules/interp/33-8350.htm#P119\\_32224](http://www.sec.gov/rules/interp/33-8350.htm#P119_32224)

<sup>49</sup> The 21 Group on Disclosure of Technology-based Intangible Assets.

Regulation FD bars disclosure to selected analysts, funds, or individual investors before making the information available to the public. If a disclosure occurs unintentionally, the violation must be rectified within 24 hours in order to avoid being qualified as selective. The regulation does not mandate that issuers make public disclosure of all material developments when they occur. Rather, it requires that when issuers choose to disclose material information they do so broadly to the investing public.

Regulation FD was contentious when it was enacted. Representatives of industry and the analyst's profession<sup>50</sup> spoke out strongly against it. The substance of their concern was that less information would be disclosed due to concerns over potential litigation. They were also concerned about increased boilerplate disclosure, potential reductions in transparency and a possible increase in the volatility of securities markets. Individual investors and representatives of retail investors, on the other hand, praised the fairness of the regulation while decrying the analysts' position as trying to maintain their privileged access to information.

The findings of recent studies on the impact of Regulation FD have disproved the direst predictions. Despite continuing disagreement, the weight of the evidence from empirical studies seems to indicate that the quantity of information has not been reduced.<sup>51</sup> On the other hand, there are findings that market volatility has increased (since information tends to reach the markets at the same time, the dampening effect of gradual leakage is reduced). It is uncertain whether the quality of information that companies make available to the public is better or worse. With respect to analyst's forecasts, it appears that their accuracy has been reduced. This is confirmed by the views of analysts associations that claim that the volume of substantive information to analysts has decreased<sup>52</sup> (though this may reflect the reduction in the information advantage that analysts previously held over the wider markets).<sup>53</sup> An unanticipated effect is the reduction in the number of companies that analysts follow because of the greater effort required in finding actionable information.

In summary, Regulation FD does not require intangibles disclosure or disclosure of any particular type; it deals with how disclosure occurs. It states that whatever disclosure occurs must occur fairly. Precisely what entails material disclosure is open to question. To date, there has been a tendency to view materiality in the accounting sense and it is possible that in drafting Regulation FD, the US SEC aimed more specifically at the disclosure of traditional financial information than intangible assets.

However, the ultimate purpose of Regulation FD is to deny unfair information advantage and it has been shown that institutional investors place great importance on non-financial measures and intangible assets.<sup>54</sup> The type of information they are looking for can be summarised as their impressions of the capacity of management to deliver on its promises. There is little doubt that this information is highly relevant and can bestow a competitive advantage. Regulation FD could thus have implications for intangible disclosures, even if the information does not meet traditional standards on materiality, to the extent that it gives analysts a competitive advantage.

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<sup>50</sup> The American Institute of Investment Management and Research (AIMR) and the Securities Industry Association (SIA).

<sup>51</sup> Talosig, Peter III (2004), Regulation FD-Fairly Disruptive? An Increase In Capital Market Inefficiency, Fordham Journal of Corporate & Financial Law.

<sup>52</sup> Reg. FD survey (2001), The Association for Investment Management and Research (AIMR).

<sup>53</sup> Scott Findlay and Prem G. Mathew, An Examination of the Differential Impact of Regulation FD on Analysts' Forecast Accuracy.

<sup>54</sup> See, for example, Measures that Matter, Ernst & Young and also Holland J., and Lev, B.

***(c) Safe harbour legislation***

Safe harbour rules are written to protect companies that disclose forward-looking information and “soft” information of a material nature from frivolous legal actions. Safe harbours are used in the US and many other countries.

While historical data is important in evaluating performance potential, the financial markets rely principally on future cash flows to determine value. Even if financial statements rarely include financial projections, various parts of the financial statements may provide information of a predictive nature that gives clues to future cash flows. Most probably Management's Discussion & Analysis would include forward-looking information of a strategic nature such as plans to develop new markets, acquisitions, divestitures, and information on certain intangible values. Some attempts have been made to improve the forward-looking content of statements in order to support the task of projecting performance, particularly in the United States where the US SEC has encouraged forward-looking statements since the 1970's and passed additional legislation in 1995.<sup>55</sup>

It has been suggested that safe harbour provisions need to be introduced into law in order to protect companies when disclosing non-traditional, non-financial information.<sup>56</sup> It has also been argued that in the absence of such protection, firms are not likely to produce the information unless required by law to do so.<sup>57</sup> Safe harbours for intangibles related information would allow lawsuits only when the company or their auditors are suspected of gross negligence.

Despite the introduction of safe harbours for future-looking information in the US, there has been little observable increase in the predictive data that companies disclose. There may be a number of explanations for what appears to be deep-seated reticence to commit forward-looking data to paper. For one, legal protections may not be sufficient to convince companies to chance legal action against them. Some companies may believe that the markets are not sufficiently interested in future-looking data to warrant running a risk. There may also be justifiable doubt among users regarding the ability of companies to take a balanced view of future events, given a natural bias to portray the company in the most positive light. On a conceptual level, it is uncertain whether the company's role is to provide projections or to provide data with which better projections can be constructed by analysts. The application of safe harbours could, nevertheless, potentially encourage more candid reporting of intangible values. Some companies would surely take advantage of the opportunity to tell a better story if better protected.

***(d) The EU Accounts Modernisation Directive***

The EU Accounts Modernisation Directive (AMD)<sup>58</sup> calls for a more in-depth review of a company's business than has been normal practice. The AMD derives from a revision of the 4th and 7th EU Directives<sup>59</sup> on the annual and consolidated accounts of companies, and the accounts of banks and other financial institutions.

The AMD came into effect on 1 January 2005 and requires companies to produce an “enhanced directors' report”. The enhanced directors' report addresses the principal risks and uncertainties that face a

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<sup>55</sup> OECD (1997), Background Document, Symposium the Role of Disclosure in Corporate Governance.

<sup>56</sup> Robert E. Litan, Peter J. W. Allison, Beyond GAAP.

<sup>57</sup> Ibid.

<sup>58</sup> Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003, the “Accounts Modernisation Directive”.

<sup>59</sup> 78/660/EEC and 83/349/EEC, respectively.

company but, unlike the Operating and Financial Review in the UK (See below), does not require reporting on the trends and factors affecting the future development of the company.

The enhanced directors' report covers a number of disclosures of both financial and social nature. A report must contain: 1) a fair review of the business of the company, and; 2) a description of the principal risks and uncertainties facing the company. The review should include a balanced and comprehensive analysis of: 1) the development and performance of the business of the company during the financial year, and; 2) the position of the company at the end of the year, consistent with the size and complexity of the business. The review must also include (to the extent necessary for an understanding of the development, performance or position of the business of the company): 1) an analysis using financial key performance indicators (KPIs)<sup>60</sup>, and; 2) where appropriate, analysis using other key performance indicators, including information relating to environmental<sup>61</sup> and employee matters.

No explicit mention is made of intangibles, human or intellectual capital. The AMD does, however, make explicit mention of employees:

*To the extent necessary for an understanding of such development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.*<sup>62</sup>

Employee matters could thus form part of the review if the board of directors feels they are necessary for the understanding of the business and/or its performance. An analysis should include KPIs, thus making the work of organisations such as IES (See below), who are trying to identify and test key human resource indicators, of great importance.

The AMD recognises the potential costs of enhanced reporting, and allowances have been made for small companies. The EU has empowered individual member states to waive the requirement to provide non-financial information for companies below a certain size. As a result, the AMD will likely be applicable primarily to large and medium-sized European companies.

The AMD has been an impetus for change in other countries such as Germany and the UK as described below. Though its impact in other European countries is outside of the scope of this report, it can be anticipated that other states are introducing changes to their national reporting schemes, thus allowing for greater disclosure within director's reports on key performance drivers of corporations. An important contribution of the AMD is its requirement for the development and use of KPIs, which should encourage consistent and comparable reporting.

#### ***(e) German Accounting Standard 15***

The German Accounting Standard 15 (GAS15) was developed in parallel to the development by the German Ministry of Justice of the Bilanzrechtsreformgesetz<sup>63</sup> implementing the EU IAS regulation, the fair

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<sup>60</sup> KPIs or Key Performance Indicators are "factors by reference to which the development, performance or position of the business of the company can be measured effectively".

<sup>61</sup> This is consistent also with Commission Recommendation 2001/453/EC on the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies.

<sup>62</sup> Article 36, Accounts Modernisation Directive.

<sup>63</sup> Translation: accounts reform law.

value directive and initial drafts of the AMD.<sup>64</sup> It was promulgated in early 2005. GAS15 covers reporting for all parent enterprises that are required by German law to prepare a Group Management Report (GMR) or consolidated accounts. The GMR corresponds to Management's Discussion & Analysis (MD&A) in the US or the Operating and Financial Review (OFR) in the UK.

In Germany, the structure and content specified in GAS15 also apply to companies who produce management reports voluntarily. As with German accounting standards, the purpose of the management report under GAS15 is to provide information that is useful for economic decision-making. GAS15 is intended to help users develop an accurate picture of the business and its position. In addition, it is supposed to describe significant and relevant risks and opportunities.<sup>65</sup> The standard recommends the following structuring for a Group Management Report:

1. Business and operating environment;
2. Results of operations, financial position and net assets;
3. The report on post-balance sheet date events;
4. The risk report, and;
5. The report on expected developments.

GAS15 differs from the AMD in that it recommends a report on future or expected developments (Bullet 5 above). With respect to future-looking information, it recommends a quantification of management's expectations for the upcoming financial year. Qualitative information is expected to cover at least two financial years.

In addition, the standard recommends the disclosure of information on the group's intangible items. Box 5 below discusses the type of intangibles that could appear in a GMR. Unlike the US SEC interpretation discussed above, and contrary to what one might expect from an accounting standard setter, GAS15 clearly recommends that disclosure of intangibles occur "irrespective of the accounting treatment". The standard also makes specific mention of human capital.

**Box 5: Excerpt from GAS 15 regarding discussion of intangibles reporting**

<p>115. <u>Disclosure of the group's intangible items is recommended.</u> This information includes an explanation of the disclosures in the context of the expected development of the group, together with significant risks and opportunities associated with this development.</p> <p>116. The information reported can give users an insight into the group's intangible resources, <u>irrespective of their accounting treatment.</u> Information about intangible items may, for example, distinguish between <u>human capital</u>, customer relationships, supplier relationships, investor and capital market relationships, organisational and process advantages, and business location factors.</p> <p>117. The various categories of intangible items listed in the previous paragraph are difficult to quantify in individual cases. <u>Wherever possible, though, the quantification of this information is recommended,</u> for example in the form of <u>key performance indicators.</u></p> <p>118. <u>Specifically, changes in human capital, customer relationships and organisational and process advantages should be discussed if they could significantly affect the economic position of the group.</u></p> <p>119. <u>In conjunction with disclosures about human capital, the provision of information about staff turnover rates, employee training measures, training costs per employee, remuneration systems and arrangements, as well as significant changes in collective bargaining and management/labour agreements is recommended.</u> Customer</p>
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<sup>64</sup> Knorr, Liesel, Secretary General, German Accounting Standards Committee.

<sup>65</sup> For more information on GAS15, see the website of the Accounting Standards Committee of Germany: [http://www.standardsetter.de/drsc/news/news\\_eng.php](http://www.standardsetter.de/drsc/news/news_eng.php).

relationships may be described, for example, by reference to customer satisfaction, customer retention rates, the market shares of principal products or value added per customer. Organisational and process advantages may be described, for example, by reference to order throughput times and information about product quality, such as reject rates per product and the level of warranty expenditure.

Note: Underlining by author.

Source: GAS15, Supplement: Recommendations for Management Reporting

These recommendations make GAS15 one of the more proactive accounting standards with respect to human resources disclosure. GAS15 also includes criteria that guide the development of a sound GMR. It establishes five principles: completeness; reliability; clarity and transparency; the conveyance of management's perspective, and; a focus on sustainable value creation. While these principles echo normal accounting principles, the threshold for reliability appears to be different from that of traditional financial statements, both with respect to the discussion of intangibles and with respect to future looking data, risks and opportunities.

### ***(f) The Operating and Financial Review in the UK***

#### *i. The origins of the Operating and Financial Review*

A number of policy initiatives lead into the Operating and Financial Review (OFR) in the UK and established the context for its treatment of human capital issues. One was the UK Company Law Review (CLR) launched by the Secretary of State for Trade and Industry in 1998. The Final Report of the CLR was published in July 2001. In July 2002, the White Paper on Modernising Company Law invited comments on the government's proposals for taking forward the CLR's recommendations. A number of the white paper's proposals addressed the need to improve the reporting framework for companies. The government accepted the CLR's recommendation that large companies should produce an annual narrative report on a company's business, performance and future plans. The white paper also proposed that the UK Accounting Standards Board (ASB) be responsible for rule making under the OFR.<sup>66</sup>

In early 2003, the Secretary of State for Trade and Industry appointed the Accounting for People Task Force to explore ways in which organisations could measure the quality and effectiveness of their human capital management. The task force found that human capital is a key source of competitive advantage and a key contributor to profitability. It concluded that successful competition required a mix of people skills and experiences that matched the needs of businesses.<sup>67</sup>

The decision to set up the Accounting for People Task Force followed one of the recommendations of the government-sponsored Kingsmill Review into Women's Pay and Development,<sup>68</sup> which noted that while human capital was a crucial element in a company's performance, it was routinely under-reported. It suggested that greater transparency was needed on human capital "to aid the efficient and well-considered allocation of resources by investors and shareholders", and that such information would benefit a broad group of stakeholders.

<sup>66</sup> For documentation on the origins of the OFR, see the White Paper at the Department of Trade and Industry website: [www.dti.gov.uk/companiesbill/whitepaper.htm](http://www.dti.gov.uk/companiesbill/whitepaper.htm) and the website of the Accounting Standards Board: [www.asb.org.uk](http://www.asb.org.uk). For the DTI recommendations on the financial review see: [www.dti.gov.uk/cld/financialreview.htm](http://www.dti.gov.uk/cld/financialreview.htm).

<sup>67</sup> For findings and recommendations, see the Accounting for People Task Force on Human Capital Management Reporting website: <http://www.accountingforpeople.gov.uk/index.htm>.

<sup>68</sup> See: <http://www.kingsmillreview.gov.uk/>.

Two European Union directives were also relevant. First, the Accounts Modernisation Directive required larger companies to include information on relevant non-financial performance indicators, including employee matters, in their directors' report. Second, the Information and Consultation Directive required companies with more than 50 employees to provide them with information about the economic situation of the company, and inform and consult with employees on a timely basis about plans which might affect them. Both directives leave it to countries to determine the specific form that communications should take.<sup>69</sup>

These initiatives influenced the OFR and its treatment of human capital issues. In its final form, the OFR was to be a mandatory report requiring "a balanced and comprehensive analysis" of a company's business. The OFR was forward-looking in nature and required information on the strategies and policies the company deployed for its long term success. It was to contain an overview of the company's objectives, strategy, past performance and future prospects and would have included, where necessary, information on employees, environmental, social and community matters.

The OFR was to be the only piece of UK legislation that required a discussion of intangible assets and human capital. Notwithstanding, the OFR was widely criticised in the human resources community for not including sufficient rules on reporting on people management issues. Despite criticism from both ends of the spectrum, the OFR was welcomed by many as a valuable tool that enabled companies to explain the meaning of their financial reports and where their business was going.

#### *ii. The shelving of the OFR*

In a surprise last minute move by the UK government, the OFR was shelved citing cost concerns and "red tape". The government's rationale was provided by the Rt. Hon. Gordon Brown MP, Chancellor of the Exchequer, on 28 November 2005, who expressed concern regarding "gold plating" of EU regulations:

*We all agree that at the heart of the modern enterprise challenge is minimising regulatory concerns.*

*The better, and... correct, modern model of regulation... is based on trust in the responsible company, the engaged employee and the educated consumer, leading government to focus its attention where it should: no inspection without justification, no form filling without justification, and no information requirements without justification, not just a light touch but a limited touch.*

*Best practice is of course for companies to report on social and environmental strategies relevant to their business. But I understand the concerns about the extra administrative cost of the gold plated regulatory requirement that from April next year all quoted companies must publish an operating and financial review....So we will abolish this requirement and reduce the burdens placed upon you.*

Differences regarding the extent to which the shelving of the OFR would save costs emerged immediately. Supporters described the shelving as a lost opportunity and a squandering of the considerable effort put into its preparation. Detractors argued that the savings would be considerable. The publication Accountancy Age suggested that the move would be unlikely to have the dramatic effect of slashing OFR costs by the 80% predicted by the UK Department of Treasury and Industry. Others went on to say that its removal had undermined well-intentioned efforts to improve the transparency of reporting to shareholders and a wide range of other stakeholders.

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<sup>69</sup> For more information on the EU Directives, see: [www.europa.eu.int](http://www.europa.eu.int).

The reaction of the accountancy bodies to the news was generally muted. Charles Tilley, chief executive of the Chartered Institute of Management Accountants (CIMA), said, “The drive to reduce the burden of red tape on business is a laudable one, but we believe wholeheartedly in the value of the OFR. Confusing the OFR with a reduction in bureaucracy risks losing the benefits it will deliver to all stakeholders, particularly shareholders.” Meanwhile, the director of auditing and accounting at the Institute of Chartered Accountants of Scotland (ICAS) said that ICAS supported “narrative statements in the interests of transparent financial reporting” and predicted that many listed groups would continue to publish an OFR in order to remain at the forefront of good reporting.

Reaction by business, which could be presumed to have welcomed the change, was mixed. Ernst & Young's head of financial reporting advisory services, Will Rainey, said the move would “delight business leaders”. Sir Digby Jones, Confederation of British Industry (CBI) director-general, welcomed the move. However, at the time of writing, the CBI website continued to be both critical and cautiously supportive of the OFR:

*The CBI recognises the benefits of informative narrative reporting and OFRs currently operating under a voluntary system underpinned by the Combined Code and the existing guidance from the Accounting Standards Board. The CBI has sought to achieve that the statutory requirements are as workable and practical as possible and do not lead to sterile boilerplate reporting dictated by legal caveats. The CBI is pleased that the Regulations make clear that the OFR is prepared with shareholders' interests paramount, and clearly all stakeholders will benefit from the information provided.*

Critical of the rollback was Jon Symonds, the CFO of AstraZeneca and board member of the UK Accounting Standards Board: “I thought the OFR was largely regarded as, certainly with its financial orientation, a sensible way to improve the quality of communication between a company and its stakeholders” and went on to say that he did not think it “terribly controversial.” The abolishment of the OFR met with a stronger response from the Institute of Directors (IoD), which said that the late decision, after companies had incurred costs to meet its requirements, showed a “slap-dash” approach to regulatory policy.<sup>70</sup>

Irrespective of these differing views, the shelving of the OFR still leaves UK companies with the need to comply with the EU Accounts Modernisation Directive with which all medium and large companies (not just quoted companies) must comply.<sup>71</sup> The AMD is almost as weighty as the OFR, with the exception that there is no need to report on factors affecting future performance. As a consequence, much of the reporting burden is unaltered.<sup>72</sup> The UK DTI suggests that companies that still have to produce an enhanced directors' report under the AMD should continue to refer to the guidance provided by the Accounting Standards Board for the OFR (See iii below), thus ensuring that the OFR's impact will continue to be felt.

### *iii. OFR Reporting Standard 1*

OFR Reporting Standard 1 (RS1) is the first reporting standard issued by the Accounting Standards Board (ASB) under its power to make standards for the OFR as set out in The Companies Act of 1985.<sup>73</sup>

<sup>70</sup> Robert Cole, The Times, December 12, 2005.

<sup>71</sup> In practice, EU legislation covers over 12 000 companies in the UK, whereas the OFR would only have affected around 1 200.

<sup>72</sup> Sourcewire.com.

<sup>73</sup> For a copy of the the Accounting Standards Board RS1 on the OFR, see: <http://www.frc.org.uk/asb/technical/standards/pub0796.html>.

The standard was to apply to quoted companies in Great Britain and to any other entities that prepare OFRs. The objective of the OFR and the supporting standard were to assist shareholders in their economic decision-making by helping them better assess corporate strategies.

RS1 sets out a flexible framework for the main elements that should be disclosed in an OFR, leaving it to directors to consider how best to structure their review in light of the particular circumstances of the entity. It does not identify any specific Key Performance Indicators (KPIs). These are required by the AMD and the OFR but are left to the companies to determine.

RS1 provides explicit direction with respect to intangibles reporting and human capital reporting in particular. It notes that information on employees must be disclosed to the extent that such information may be required to help users assess the strategies of the enterprise and the potential for those strategies to succeed. Furthermore, employee issues, even if not considered crucial for evaluating corporate strategy, figure in a list of matters that directors must consider in order to comply with the objectives of the OFR.<sup>74</sup> The requirement to describe the resources available to companies is reproduced in Box 6, below.

#### Box 6: Resource descriptions under OFR RS1

The OFR shall set out the key strengths and resources, tangible and intangible, available to the business, which will assist in the pursuit of its objectives and, in particular, those items that are not reflected on the balance sheet. Depending on the nature of the business, these may include: corporate reputation and brand strength; natural resources; employees; research and development; intellectual capital; licenses, patents, copyright and trademarks; and market position.

Source: OFR RS1, paragraphs 52 and 53. Underlining by author.

The use of KPIs for human capital is suggested though the RS1 acknowledges the difficulty of developing specific indicators:

*On KPIs relating to human capital, the Board noted the conclusion of the report of the Task Force on Human Capital Management 'Accounting for People' that: "there is no single set of HCM practices widely accepted as "best practice" applicable to all organizations, nor agreement on a set of universally relevant indicators". A report published in April 2005 by the Chartered Management Institute (CMI) 'Getting the basics right: a guide to measuring the value of your workforce' reaffirmed this view: "it is difficult at this point of our investigation to state conclusively which human capital measures will provide universal guidance to managers in the stewardship of an organisation's workforce".<sup>75</sup>*

The paragraph goes on to note that further work needs to be done in this regard.

RS1 is accompanied by practical implementation guidance (IG) that includes a detailed discussion of employee related matters:

*Employees may be a particularly key resource--and accordingly a key risk--for many entities. The strengths of a company's workforce and the ways it is managed can play a major role in both current and future company performance. Entities will need to be able to recruit and retain the staff they need to achieve their business strategies. Accordingly, the risks and uncertainties associated with the management of recruitment and retention of staff with the particular skills*

<sup>74</sup> See, specifically, A7 to A11, OFR RS1.

<sup>75</sup> Appendix C, paragraph C44, OFR RS1.

*required for the entity's strategies could have a significant impact on the entity's future development and performance. For example, poor employment relationships can carry the cost of costly litigation, low workforce morale and ultimately affect company reputation. In addition, directors will need to consider their employment policies and practices to assess which aspects are relevant to understanding the entity. For example, the degree to which the human resources of the entity represent a significant advantage or are critical to a key product, service or process.<sup>76</sup>*

In addition, the implementation guidance to the standard provides a list of potential indicators that could be used for reporting. These indicators are reproduced in Box 7, below, and coincide broadly with the indicators identified under the IES project described below.

**Box 7: Illustrative indicators as per Implementation Guidance (IG26)**

In order to assess the employee performance and development, the following areas, along with related performance measures, may be helpful:

- **Employee health and safety** (which could also be considered a "social matter")... lost days to injury, levels of occupational related diseases in the workforce, compliance levels with working hours directives;
- **Recruitment and retention**--employee turnover, retention rates, remuneration policies, number of applicants per post, offer/acceptance statistics, levels of skills shortages;
- **Training and development**--hours spent on training, number of courses taken, leadership/career development;
- **Morale/motivation**--employee feedback results, absence rates, levels of employee engagement;
- **Workforce permanence and profile**--employee productivity, revenue/profit per employee, diversity..., number of professionally qualified employees.

Source: IG26 of OFR RS1

IG27 notes that these indicators are merely examples that could serve as KPIs. Should they not be appropriate to the individual business, other indicators could be developed which might not be considered KPIs though they would be accepted as providing additional evidence.

In summary, the first OFRs and the first application of RS1 were expected in April 2006. The OFR had been interpreted as an encouragement for better reporting on intangible assets and human capital and the benefits of enhanced reporting were considered to be significant by investors, directors, advocates for better governance and social interest groups. This did not prevent the OFR from being shelved. Whether or not the costs were properly assessed, the OFR ultimately foundered on a regulatory philosophy that in the words of the Rt. Hon. Gordon Brown requires "not just a light touch, but a limited touch". While some companies will choose to voluntarily report according to the OFR and its supporting standard in order to place themselves at the forefront of reporting, the rejection of the OFR will likely dampen enthusiasm for enhanced reporting in the UK and influence other countries in their assessment of how to implement enhanced business reporting under the AMD.

<sup>76</sup>

Implementation Guidance IG24, OFR RS1.

**(g) Other policy reports and studies**

*i. The PRISM Report*

The PRISM initiative was started in January 2000 by the European Commission Directorate-General for Enterprise Affairs. The report represents the culmination of a two-year programme directed at gaining a deeper understanding of the influence of intangibles on the modern economy. It reiterates many of the basic observations of other works cited in this report, noting that the existing reporting model is overly rooted in the notion that growth and performance lie in the accumulation of fixed assets such as property, plant and equipment. It goes on to say that accounting techniques do not adequately describe how value is created in a modern economy.

One of its prime conclusions is that “hidden” productive capacity demands new measurement tools. The report suggests that intangibles, such as core competencies, competitiveness and the calibre of management have, in fact, been incorporated in credit risk analysis for some time, albeit intuitively and subjectively, and with neither a common language nor an explicit measurement framework. Rather than a revolution, the report argues that a gradual shift has taken place in the drivers of growth and productivity. This shift was followed by the recognition of the importance of intangible values as a driving force in a modern economy.

The PRISM report advises caution in expanding disclosure to a broad range of intangibles. In contemplating the expansion of disclosure on non-financial elements of corporations, it suggests that the “so what?” test be applied in order to confirm the utility of any proposed reporting. It is acknowledged that companies are subject to increasing demands for disclosure on more and more issues, but without any real sense of the purpose of the disclosure, who might use it, or how it might be used. It questions how to interpret, for example, the observation that 10% of the employees of Company A have a PhD, versus only 7.5 % in Company B. In the absence of further contextual information, this observation could be interpreted as being positive, negative, neutral or irrelevant.

The report also argues that the purpose of disclosure is not just for the financial markets and not just an attempt assign value to a company’s intellectual capital. Rather, the aim of disclosure and measurement is to encourage a more profound consideration and discussion of the drivers of economic value. This enhanced consideration of intangible drivers is supported by the creation of a dialogue around how value is created, irrespective of whether the dialogue is internal or external.

The PRISM report considers that the time has come for different guidelines and methodologies to converge. It cites the work of David Young who suggests the creation of an internationally accepted conceptual framework for intangibles reporting which could be given the designation General Accounting Intangibles Principles (GAIP).<sup>77</sup> It is recognised that creating a common framework, similar to that which exists for accounting is a daunting challenge. The report goes on to assert that the prospect of convergence between the existing frameworks and guidelines is still some way off and that some of the technical problems may prove to be intractable.

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<sup>77</sup> David Young, Boston School of Management.

ii. *THE EU Study on the Measurement of Intangible Assets and Associated Reporting Practices*

The EU Study on the Measurement of Intangible Assets and Associated Reporting Practices<sup>78</sup> is a comprehensive compilation of the works of a number of researchers that cover many aspects of the intangibles question. Among other things, the study describes the shift from an economy where production is based primarily on tangible assets to an economy where intangible assets are no longer merely supplements to tangible assets but, rather, the source of value creation.

The study also seeks to assess the policy implications of this shift. It examines current regulatory frameworks and reviews the accounting treatment for intangible assets in a number of countries. It summarises the findings of a number of studies on the impact of current reporting practices and illustrates some of the new approaches to the measurement, valuation and reporting of intangibles. It also includes the results of a survey designed to relate the views of stakeholders (primarily from the financial services industry) on the type of information they consider important for reporting. The study concludes with a large number of recommendations.

The overall tenor of these recommendations is to say that the policy objective of the EU should be to reform the measurement and reporting of intangibles by providing rules and conventions, and administrative instruments to penalise those who do not follow the rules. The study takes the position that while voluntary initiatives are to be encouraged, regulatory intervention is required:

*The most disappointing aspect of the work on intangibles, from the point of view of progress, is financial reporting. Despite numerous books, research reports, conferences and policy declarations highlighting the serious deficiencies in corporate financial reporting resulting from the neglect of intangibles, and the harmful consequences of such deficiencies, no discernible progress had occurred in this area.*

*This area, impacting wide economic spheres, is just too important to leave to the accountants currently in charge of standard-setting. Policymakers have to take an active role in the standard setting process of financial reporting, with the objective of advancing without delay the reforms in corporate accounting and reporting systems needed to reflect the realities of intangibles-intensive business enterprises, and their vulnerabilities.*<sup>79</sup>

In addition, the study expresses dissatisfaction with the way intangibles issues have been handled by accounting standard setters. It supports direct intervention in the standard setting mechanism, which it asserts is justified by market failure.<sup>80</sup> The specific recommendations of the study are to create a task force responsible for addressing reporting problems. The task force would consider, among other things: 1) the creation of taxonomies for measuring and reporting, and convergence between existing reporting models; 2) the identification of key internal measures to be consistent with external reporting; 3) international agreement on a minimum set of external reporting indicators; 4) the reform of statutory reporting requirements; 5) further encouragement of voluntary initiatives in addition to mandatory reporting;

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<sup>78</sup> The Study was commissioned by the “Enterprise” Directorate General of the European Commission, and carried out by an international research team, headed by the Department of Economics of the University of Ferrara, which includes the Stern School of Business, New York University, and the Department of Accounting and Information Systems of the Faculty of Economics and Commerce of the University of Melbourne.

<sup>79</sup> Chapter 7.

<sup>80</sup> Chapter 3.

6) research on recognition criteria for assets, and; 7) research on the potential of a “unified sustainability report” that would combine financial, social and environmental reporting into one document.<sup>81</sup>

The study includes the findings of a survey of users on their preferred approaches to intangibles reporting and the prospects for capitalising certain intangibles. The responses to the survey reflect primarily the views of financial intermediaries and companies. Some of its key findings are that: 1) analysts are some of the most important users of financial statements; 2) problems stemming from accounting definitions of assets are not considered insurmountable, and; 3) the two greatest impediments to the capitalisation of intangibles are the absence of internal systems for tracking intangibles and a lack of internal expertise.

A number of elements of the survey shed some light on the perception of users on the relevance and use of human capital related information. While the study cites research on the importance of employees on firm performance,<sup>82</sup> survey respondents assigned a relatively low priority to employee related disclosure. Table 1, below shows that “detailed information on employees” is considered the least important factor among a list of non-financial indicators for assessing firm performance and value.

**Table 1: Percent of respondents in each ranked category: importance of non-financial information for assessing firm performance and firm value**

<i>Ranking of Information Categories</i>							
Type of Information	Most Important	2 <sup>nd</sup> Most Important	1 <sup>st</sup> and 2 <sup>nd</sup> Most Important	3 <sup>rd</sup> Most Important	4 <sup>th</sup> Most Important	5 <sup>th</sup> Most Important	Least Important
Current Non-financial Performance Information	28.2%	28.2%	56.4%	25.0%	12.5%	6.3%	3.1%
Forward Looking Non-financial Information	23.1%	12.8%	35.9%	31.3%	9.4%	9.4%	15.6%
Information on Management's Strategies and Plans for the Future	28.2%	30.8%	59.0%	9.4%	15.6%	9.4%	9.4%
Information About Unrecognized Intangibles	10.3%	15.4%	25.7%	12.5%	21.9%	21.9%	12.5%
Detailed Information on Employees	5.1%	5.1%	10.2%	12.5%	18.8%	28.1%	34.4%
Detailed Information on Customers	2.7%	18.9%	21.6%	18.8%	18.8%	21.9%	12.5%

Source: Table 6.7, EU Study on the Measurement of Intangible Assets and Associated Reporting Practices

According to the table above, only 10.2% of respondents ranked detailed employee information as one of the two most important factors in assessing firm performance and value, while the largest proportion of respondents (34.4%) ranked this as least important.

<sup>81</sup> Taken from a much broader set of policy recommendations found in Chapter 7.

<sup>82</sup> See also section of this report on the Institute of Employment Studies Report, which contains an extensive review of the literature linking employees to firm performance.

There is also some indication that larger firms are more likely to routinely collect the information necessary to report on internally generated intangible assets. (See Table 2, below). This suggests that information on people investments may be available for external reporting among larger companies.

**Table 2: Estimates of the percentage of firms routinely collecting information on internally generated intangible assets**

	Small Firms Less than 100 Employees		Medium Firms 100-200 Employees		Large Firms	
	Min – Max	Mean (Std. Dev)	Min – Max	Mean (Std. Dev)	Min – Max	Mean (Std. Dev)
Computer Related Investment	0 – 100	50.00 (35.21)	30 – 100	71.82 (26.39)	60 – 100	91.80 (16.00)
Product and Technology	0 – 100	33.50 (35.12)	10 – 100	50.00 (31.26)	40 – 100	85.85 (20.20)
Patents, Licences, Trademarks, etc.	0 – 100	55.45 (33.87)	20 – 100	74.58 (31.00)	50 – 100	89.17 (19.28)
Investments in People	10 – 100	33.33 (29.58)	5 – 100	52.50 (29.17)	10 – 100	70.83 (34.20)
Supplier Networks and Other Alliances	0 – 50	17.00 (19.88)	0 – 100	33.70 (25.80)	0 – 100	56.67 (41.50)
Infrastructure	0 – 80	27.00 (33.46)	0 – 80	30.71 (31.90)	20 – 100	57.00 (35.60)
R&D Leading to New Products/Technologies	0 – 100	50.00 (38.00)	30 – 100	70.00 (24.90)	50 – 100	89.17 (19.29)
Marketing and Sales Capabilities	10 – 100	41.50 (34.48)	20 – 100	62.00 (24.80)	50 – 100	86.67 (15.50)

Source: Table 6.9, EU Study on the Measurement of Intangible Assets and Associated Reporting Practices

The data also suggests that small and medium-sized companies are much less likely to routinely collect all manner of information on intangible assets, in particular their investments in people. While the reasons are not explored, costs, internal expertise, and the perceived utility of such information could be explanations.

In terms of the accounting treatment of people investments, the vast majority of respondents to the survey (75.8%) favoured expensing people investments (the current accounting practice) over capitalisation. (See Table 3, below).

**Table 3: Treatment of internally generated intangible assets and valuation method**

	Expense %	Valuation Method if Expenditure is Capitalised*			Other or No Opinion %
		Market Value	Cost Value	Real Options	
Computer Related Investment	21.2	16.7	66.7	12.5	0
Product and Technology	41.2	15.0	60.0	15.0	5.0
Patents, Licences, Trademarks, etc.	16.1	30.8	42.3	11.5	11.5
Investments in People	75.8	0	25.0	50.0	0
Supplier Networks and Other Alliances	67.7	0	12.5	62.5	27.9
Infrastructure	58.8	8.3	75.0	8.3	0
R&D Leading to New Products/Technologies	30.3	9.5	57.1	28.6	0
Marketing and Sales Capabilities	55.9	25.0	41.7	25.0	0

Note: The valuation method (columns 2, 3 and 4) is only for those who chose the capitalisation option. The number of respondents is relatively small.

Source: Table 6.10, EU Study on the Measurement of Intangible Assets and Associated Reporting Practices

Furthermore, in the event that people investments were to be capitalised, no respondents (0%) felt that a market value could be assigned to people investments, 25% felt that the cost of investment would be the appropriate figure while 50% felt that a “real option”<sup>83</sup> valuation method was most appropriate. This is a potentially important finding that could have implications for how human capital information is best reported. It indicates that while capitalisation may be a promising approach for some intangibles (such as patents, licenses, trademarks, etc.) it may not be the most appropriate method for recording and describing people investments.

Among the studies considered in this report, the EU study is one of most comprehensive. It argues most strongly for policy intervention, particularly in the accounting standard setting process. While the study recognises the importance of human capital as a primary component of intangible assets, it devotes only modest attention to the specificities of human capital reporting. However, the findings of the survey, conducted as part of the study that examined user demand for intangibles data, suggest that traditional accounting statements might not be well-suited for conveying human capital information.

<sup>83</sup>

A real option is not a derivative instrument, but an actual option in the sense of a "choice" that shows what a business might gain by making an investment or undertaking an action. For example, if the company invests in more highly skilled employees, it may be able to produce higher-end products, which can be re-sold at a higher price. This investment choice opens opportunities, which have value for the company. Practically, a decision tree must be plotted, showing different potential outcomes of a choice and the probability of each outcome. Cash flows are then assigned to each outcome. Generally speaking, analysts may have a tough time trusting real option pricing as a valid method since it implies considerable judgement in assessing future events and probabilities. On the other hand, real options encourage forward-looking thinking about hidden assets. (Adapted from Investopedia.com).

*iii. The Interim Report (2005) of the Subcommittee on Management & Intellectual Assets, New Growth Policy Committee, Industrial Structure Council, Japan*

The Subcommittee on Management & Intellectual Assets in Japan was established under the New Growth Policy Committee of the Industrial Structure Council of the Ministry of Economy, Trade and Industry (METI) in February 2005. The report of the subcommittee assesses the role of intellectual capital internationally with a view towards promoting intellectual capital based management, with a particular focus on disclosure mechanisms.

The overall objective of the subcommittee's recommendations is to ensure the future competitiveness of Japan and Japanese corporations in conditions of heightened global competition. The interim report observes that it has been difficult for Japanese companies to extract themselves from their recent economic malaise and to compete based on traditional factors such as cost and economies of scale. The solution that the subcommittee proposes is the revitalisation of Japanese companies through differentiation and competition based upon intangible assets.

The interim report suggests that it is not sufficient for companies to focus narrowly on profits and returns to shareholders. Japanese corporations, it is argued, may be overly affected by "the ideas of Western-style accounting" that place too much emphasis on short-term profit. Both the profit motive and the shareholder focus that have prevailed in recent years are to be attenuated in favour of a focus on stakeholders and broader societal outcomes. The report also cites concerns regarding low stock market valuations: Japanese corporations are dissatisfied with being undervalued in the markets and unhappy with the exclusive focus of the markets on financial indicators.

The alternative that is proposed to shareholder and profit-based management is intellectual capital-based management:

*Then, the question is whether there is any management that is based on something other than shareholder supremacy? One of the answers is represented by intellectual assets based management. In this respect, intellectual assets based management has a common nature in many ways with what the Japanese corporation has historically cherished.<sup>84</sup>*

The report submits that traditional Japanese cultural and business values could be better recognised by some form of intangibles reporting, and that a new form of reporting is necessary for Japan's unique ideas and practices to be properly assessed. Underlying this argument for better intellectual capital reporting is the concern that another country's values could be imposed on Japan by the expanding use of international standards. Related to this concern is the proposal that Japanese values such as "sustainable profit" and responsibility towards a variety of stakeholders should be better incorporated into international standards. It is hoped that "the so-called Japanese-style of management will be re-acknowledged, and more and more Japanese corporations will regain confidence and be able to execute management policies in their own way."

Among the many expected benefits of a shift towards a greater appreciation of intangible values is that the hidden worth of corporations will be recognised and that turnover (sales) and share prices will rise. A better appreciation of hidden values is also expected to contribute to improved management of technology and human resources. According to the report, it is also expected to help attenuate certain negative aspect of the economy by discouraging: a) corporate acquisitions (through better company valuations); b) the unintended out-flow of technology and know-how, and; c) the "harmful influence of imposed international standards".

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<sup>84</sup>

Paraphrase removed.

Like the EU study cited above, the report argues that the primary objective of disclosure is to help corporations appreciate the merits of intangibles management and innovation through a process of disclosure and feedback: "This disclosure will enable them [companies] to internally organize and control what they have not properly controlled in the past, which will increase the possibility for sustainable profits." In short, disclosure is viewed as a tool to improve the internal decision-making of corporations.

The report outlines areas in which a policy intervention is needed to assist companies in their intellectual capital management. They are to: a) create a framework of corporate values and intellectual assets and communicate these values; b) promote corporate management and internal control of intangible assets, and; c) to formulate guidelines and indicators and encourage disclosure based on the guidelines. The subcommittee acknowledges the importance of voluntary disclosure, but foresees an eventual move towards mandatory disclosure.

The interim report of the subcommittee is interesting for its justification of intangibles disclosure. It acknowledges the importance of profits, but calls for greater attention to broader societal benefits. The report does not develop notions of human capital at any length.

\* \* \* \* \*

The above section describes a mixed group of policy reflections and responses related to the intangibles issue. While there is no shortage of criticism of the traditional accounting model, no countries have initiated a process of radical change that would place intangible assets and intellectual capital at the centre of a new model. Significant changes have, nevertheless, occurred. Efforts have been made to improve reporting through better descriptions of business operations and performance. Most of these efforts seem to be directed at improving reporting within directors' reports in the EU, and MD&As in the US, or their equivalents elsewhere.

The MD&A is an area that is increasingly accepted as the appropriate place to include expanded business reporting.<sup>85</sup> Attempts to enhance MD&A disclosure do not focus on intangibles per se; they are focused on enhancing the overall quality of the picture of the company. Where intangibles and, more specifically, human resources contribute significantly to this enhanced view, the door opens for greater intellectual capital reporting.

The Accounts Modernisation Directive appears to have contributed appreciably to greater coverage of intangibles and intellectual capital in reporting. It can be anticipated that it will continue to have an impact in European countries and that it could contribute to a more permissive reporting environment.

Notwithstanding the rejection of the Operating and Financial Review in the UK, the experience with the OFR and its accompanying reporting standard provides some indications of how intangible values can be integrated into an existing financial reporting framework. In addition, both GAS15 in Germany and the OFR Reporting Standard 1 show how rules and principles that are traditionally applied in the accounting framework (such as completeness, reliability and clarity) can be used to enhance the quality of intangibles reporting. This may mean less flexibility and creativity for companies but can also be welcomed as a way of bringing intangibles reporting into the mainstream. The focus on KPIs in the AMD, GAS15 and the OFR are important in this context since they underscore the importance of consistent and robust indicators. Those organisations working on developing and promulgating indicators may find this high-level support a boon.

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<sup>85</sup> David Martin, Director of the Division of Corporation Finance, at the annual Practising Law Institute "SEC Speaks" conference held in Washington, D.C. on March 2-3, 2001.

On the other hand, costs and red tape, and so-called “gold plating” of regulation caused a major rollback of what looked to be a promising reporting initiative in the UK. No future efforts in this area can reasonably ignore the appropriate balance between costs and benefits, or disregard a careful consideration of the appropriate role of government in stipulating disclosure. Clear notions of who the users are, and what the expected benefits of disclosure will be, have to be made explicit in order to survive challenges.

#### 4) New reporting models

Many different models for measuring, valuing and reporting on intangibles have been developed, the best-known of which are: the Skandia Navigator, the Balanced Scorecard, the Intangible Assets Monitor, the Value Chain Scoreboard and the Value Creation Index.<sup>86</sup> These tools were developed in the 1990s and have been widely tested and refined. Most were designed to improve the internal management of intangibles though they can also serve as the basis for intangibles reporting. Among these, the Balanced Scorecard has arguably received the most acceptance among businesses though no one approach is universally accepted.

The MERITUM and DATI Guidelines are newer efforts to systematise the management and reporting of intangibles. Each has its strengths and flaws. Each has a view on how intangible assets contribute to value creation and how to talk about them. Of special note is the work of the Institute for Employment Studies (IES), which pursues a narrow focus on human capital issues. The more recent projects are described in somewhat more detail below.

##### *(a) The joint MERITUM project*

The relevance of the MERITUM project is that it was the first attempt to create international a conceptual framework for intangibles management and reporting.<sup>87</sup> MERITUM stands for MEasuRing InTangibles to Understand and improve innovation Management. MERITUM was a joint research project involving universities and researchers in six countries including, Denmark, Finland, France, Norway, Spain and Sweden. The study was funded by the European Union and was conducted between 1998 and 2001 with guidelines published in 2002.

The philosophical underpinnings of MERITUM come from the “broken accounting model” view. The basic problem that is identified is that neither management information systems nor accounting principles or standards allow for the disclosure of intangibles. The guidelines state: “It is ... widely agreed that annual reports do not provide a sound basis to draw efficient estimates of the future payoffs that can be expected from companies, nor to assess the risk associated with them.”<sup>88</sup> The result of this gap is that management bases its decisions on financial statements that do not reflect the intangible determinants of corporate value, thus causing economic losses to firms and stakeholders.

The guidelines are addressed to firms seeking to implement systems for controlling and managing intellectual capital and firms contemplating external disclosure. Their objectives are to: 1) increase management efficiency, and; 2) assist companies in producing intangibles reports destined for the use of capital providers. The Guidelines are considered a general starting point with further work being required that would provide more specific guidance.

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<sup>86</sup> Edvisson, Kaplan & Norton, Sveiby Lev, and Ittner, Lacker, Cap Gemini Ernst & Young Center for Business Innovation respectively.

<sup>87</sup> The website address of the MERITUM project is: <http://www.uam.es/proyectosinv/meritum/>.

<sup>88</sup> MERITUM Project (2002), Guidelines for Managing and Reporting on Intangibles, p. 57.

### Box 8: Summary of the MERITUM Guidelines

**The structure of the guidelines:** The guidelines have the following structure: 1) the justification for the guidelines; 2) a conceptual framework covering theory and definitions; 3) the process of designing and implementing an intangibles management information and monitoring system; 4) guidance on how to prepare an intangibles report and; 5) practical recommendations on producing an intangibles report.

**1) The justification for the guidelines:** The need for guidelines is based on the grounds that: 1) company information systems do not allow for efficient management since they do not capture information on intangibles, which are fundamental determinants of the firm's success, and; 2) annual reports do not provide a sound basis to evaluate risks and returns of companies. It is argued that intangibles are the key drivers of value creation in the knowledge economy. Despite their importance, both internal and external reporting are infrequent. This is attributed mainly to accounting standards which prohibit recognition of investments in intangible assets. Financial statements do not, as a result, provide an accurate view of the firm's financial position.

The guidelines warn of faulty economic decision making, the loss of business opportunities, underinvestment in intangible assets, potential for insider-trading and rent-seeking behaviour due to information asymmetries, the undervaluation of companies and volatility in share prices. They also suggest that disclosure may help overcome many of these problems. Disclosure is supposed to improve public policy and economic growth by promoting innovation. The guidelines are not meant to change accounting standards, at least not in the short term.

**2) The conceptual framework:** The guidelines note the absence of a generally accepted definition of intangibles and the interchangeable use of terms such as intangibles, intellectual or knowledge capital, and intangible assets in the literature and in practice. They provide a definition that reflects those commonly found definitions in the literature: Intangibles ... "are generally defined as non-monetary sources of probable future economic profits, lacking physical substance, controlled (or at least influenced) by a firm as a result of previous events and transactions (self-production, purchase or any other type of acquisition) and may or may not be sold separately from other corporate assets." The commonalities with accounting definitions of assets are marked.

Accounting standards recognize some intangible assets such as copyrights, franchises, patents, trademarks, brand names, etc. However, accounting principles have asset recognition criteria that require the company to be able to control the asset and measure it reliably. Much intellectual capital does not pass recognition tests.

Intellectual capital is defined as falling into three broad groups: 1) *human capital*, which is the knowledge that employees take with them when they leave the firm. It includes the knowledge, skills, experiences and abilities of people; 2) *structural capital*, which is defined as knowledge that stays within the firm at the end of the work day. It comprises organizational routines, procedures, systems, cultures and data bases, and; 3) *relational capital*, which is a resource linked to the external relationships of the firm such as customers, suppliers or R&D partners.

The conceptual framework also distinguishes between *static* and *dynamic* intangibles. The first can be viewed as a stock or inventory, while the later comprises activities.

**3) Designing a management information and monitoring system:** This section describes how to adapt management information systems to include intangibles. Three phases are proposed: 1) *identification* of intangibles; 2) *measurement*, and; 3) *action*. The starting point is the identification of the firm's vision and the intangibles that are critical to value creation and achieving strategic goals. Once critical intangibles and their causal effect on outcomes have been identified, indicators are selected. Indicators should be: comparable; reliable; objective; truthful; verifiable and feasible. These echo the characteristics of good indicators in a financial accounting framework. The third phase implies integration of intangibles into company decision making and includes activities designed to bring intellectual assets to bear on performance.

**4) Preparing intellectual capital reports:** The Intellectual Capital Report is the conclusion of the intellectual capital management process. It entails communicating to stakeholders (without preference among stakeholder groups) on the fundamental determinants of firm value. It includes three parts: 1) the vision of the firm; 2) a summary of intangible resources and activities, and; 3) a set of indicators.

In order for reports to be relevant, they must have two characteristics. There must be a link between the disclosed information and management activities, and there must be value to disclosure. Disclosure must improve—and not merely describe—relationships with customers, employees, partners and other stakeholders.

**5) Practical recommendations on preparing intellectual capital statements:** This section makes recommendations regarding: 1) how to collect information; 2) who should prepare reports, and; 3) the frequency of reporting.

Source: MERITUM Guidelines for Managing and Reporting on Intangibles.

The MERITUM guidelines focus on the management of intellectual capital. They also describe disclosure. However, this is not their primary focus. The MERITUM guidelines are an initial exploration and provide much good information but are not a full-fledged conceptual framework that can be used to develop reporting standards and guide intangibles reporting.

**Box 9: E\*KNOW NET (the MERITUM sequel)**

MERITUM was followed by a project known as E\*KNOW NET, also funded by the EU. E\*KNOW-NET's objective is to create a global network of researchers, firms, investors, financial and investment analysts, policy makers, and accounting standard-setting bodies to exchange experiences and knowledge on intangibles and intellectual capital, and assist businesses in improving their management of intellectual capital and intangibles. At present, members are predominantly European academics.

Source: E\*KNOW NET website. See: <http://www.urjc.es/innotec/whatis.php>.

MERITUM was a good first step in the development of a conceptual framework for intangibles management and reporting. Their impact has been one of encouraging further thought and experimentation. MERITUM has been followed by efforts both in traditional areas of reporting and in specialised areas such as human capital reporting.

***(b) The Danish Agency for Trade and Industry***

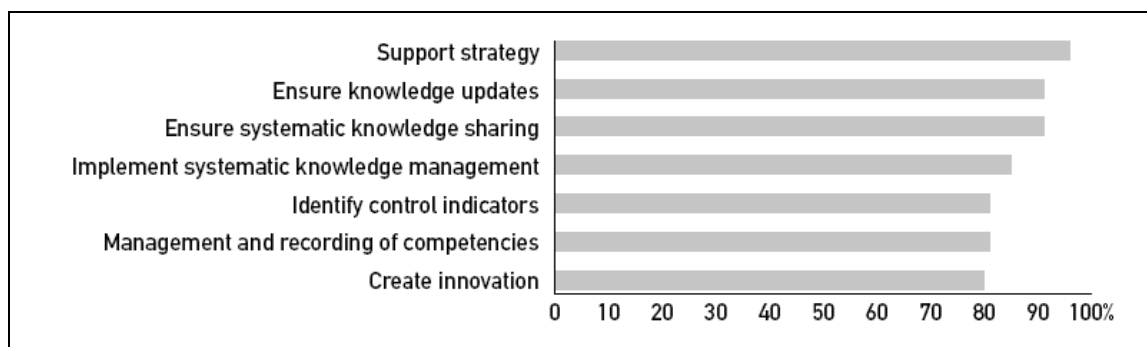
The work of the Danish Agency for Trade and Industry (DATI) has resulted in guidance on preparing intellectual capital statements and separate guidance on how to interpret them. Both are discussed in this section.

*i. The New Guidelines: Creating, Using and Reporting Intellectual Capital Statements*

The original DATI guidelines on intangible assets were completed in 2000. In their preface, the Minister for Science, Technology and Innovation states that their objective is to help Danish companies compete by helping them manage their intellectual capital. The original guidelines were then refined and revised. The resulting report, entitled Intellectual Capital Statements—The New Guidelines, was published in 2003. The New Guidelines apply to both small and large companies in a variety of different industrial sectors.

The New Guidelines provide guidance on how to structure the intellectual capital management process: Part 1 focuses on the intellectual capital statement as a knowledge management tool. Part 2 describes how to prepare intellectual capital statements. Part 3 gives a number of directions on how to communicate and write external intellectual capital statements. Part 4 gives practical suggestions as to how the intellectual capital statement work can be organised.

The New Guidelines list the objectives of companies with respect to their intellectual capital statements. First among the objectives is to support the achievement of the company's strategic goals. The remaining five objectives have to do with some aspect of the management of knowledge capital. The final objective is to encourage innovation within the enterprise. The proportion of companies that subscribe to these different objectives is illustrated in Graphic 2, below.

**Graphic 2: Proportion of companies with the following internal intellectual capital statement objectives:**

Source: Intellectual Capital Statements—The New Guidelines. Survey of companies that have worked with intellectual capital statements

The New Guidelines contain guidance on the purpose and method of external communications. External communications are directed at a broad group of users and are not uniquely or primarily focused on the financial markets. Even if investors are listed as potential users, there is no explicit mention of the purpose of statements to inform on cash flows, value creation or profitability. The objectives or “relevance” of intellectual capital reporting under the new DATI guidelines are summarised in Box 10, below.

**Box 10: Relevance of external communications to a broad body of potential users**

- *To the company* it communicates identity, who “we” are, and what the development strategy is.
- *To potential employees* it gives an impression of what it is like to be an employee including how their resources will be used and developed.
- *To customers* it sends a signal of what it is like to be a customer, including into the future.
- *To co-operative partners* it illustrates what it is like to co-operate with the company.
- *To investors* it documents the company’s ability to survive future competition.
- *To citizens* it explains what is being done to secure the best possible services for users of public services for example.
- *To the political system* it gives insight into how the companies are run, allowing politicians to better estimate its competencies and quality.

Source: Intellectual Capital Statements—The New Guidelines. (Italics by author).

External reporting also serves to communicate the results of intellectual capital management: “Intellectual capital statements can also be used to communicate knowledge management’s objectives, initiatives and results to a number of target groups”. External reporting under the New Guidelines is thus to inform users on the stewardship of the company’s intellectual assets and as a general indicator of the ability of the enterprise to “survive future competition”.

Companies have different views with respect to external reporting. Here objectives fall into a number of categories: to demonstrate that human resources and knowledge are important and to communicate the

company’s capacity to innovate and be flexible. Intellectual capital reporting also has a marketing objective: to create an understanding of products and services, and attract and retain customers. The objectives of external reporting from the perspective of the company are illustrated in Graphic 3, below.

**Graphic 3: Proportion of companies with the following external intellectual capital statement objectives:**



Source: Intellectual Capital Statements—The New Guidelines. Survey among companies that have worked with intellectual capital statements

Foremost among these is to show that human resources are the company’s most important asset. While some 70% of companies see intellectual capital reports as a supplement to financial reports, reporting as a supplement to traditional financial statements comes 7<sup>th</sup>.

Part 3 of the New Guidelines gives a number of directions on how to how to structure external intellectual capital statements. These are summarised in Box 11, below.

**Box 11: External intellectual capital statement structure**

1. The *annual report* allows the management (and the board of directors) to explain the company’s objectives, challenges and results with respect to knowledge resources.
2. A *company description* or profile generally contains the following information: the company’s history; the company’s products or services; the company’s results; and the company’s organisation.
3. The *knowledge narrative* is concerned with: the company’s products, services and users; the value proposition (referred to as “use value” in the guidelines); knowledge resources, and; a general explanation and description of management challenges.
4. The *intellectual capital statement model* gives the total overview from knowledge narrative to indicators.
5. *Management challenges*, initiatives and indicators.
6. *Accounting policies* shows how figures are defined.

Source: Intellectual Capital Statements—The New Guidelines.

The New Guidelines do not provide specific indicators. They welcome flexibility and innovation: “As there are no formal rules for how an external intellectual capital statement should be structured, there is great opportunity and good reason to be creative”. The identification of indicators thus lies with the company, which can tailor them to its needs as it sees fit.

The Danish Financial Statements Act does not require companies or public institutions to prepare intellectual capital statements. However, when addressed to traditional financial statement users, regulation comes into play and greater rules, rigidity and standards for disclosure apply. When a supplementary report is made public, the board of directors and the management are to ensure that the intellectual capital statement provides a fair picture of the company. The information must be relevant, reliable and comply with fundamental statutory requirements. There is no audit requirement for intellectual capital statements, but if a summary of the intellectual capital statement is incorporated in the annual report it becomes subject to the same audit requirements as the rest of the annual report.

The New Guidelines are primarily a tool to manage intellectual capital and secondarily to communicate externally. Their purpose is to support the achievement of overall corporate strategy through a better use of intellectual capital that, in turn, supports the achievement of a variety of operational goals and outcomes. They cover all aspects of intellectual capital management, including human resources, though human resources are not their central focus.

#### *ii. Analysing Intellectual Capital Statements*

The New Guidelines are complemented by a DATI publication that aims to help financial analysts interpret intellectual capital statements. The proposed analysis is designed to yield insights into the following three questions:

- 1) *Resources*: How are the company's knowledge assets composed? This item provides the basis for a "portfolio assessment" of the company, not dissimilar from a balance sheet listing of assets. Information is intended to allow intellectual capital analysts to decide whether the company's knowledge resources are sufficient to meet its competitive needs.
- 2) *Activities*: What has the company done to strengthen its knowledge assets? This item describes management's ability to develop employees, the organisation and customer relationships.
- 3) *Effects*: What are the effects of the company's knowledge management? This item allows the analyst to assess the company's knowledge management systems.

These questions are asked with respect to each of the four main knowledge resource categories usually found in intellectual capital statements: 1) employees; 2) customers; 3) processes, and; 4) technologies. An excerpt of the report on Systematic, a Danish company, is reproduced below. Systematic is a small privately held software and systems developer. As such, its operations are knowledge and human resource intensive. It would be a classic example of a company that would have relatively few hard assets on its traditional financial statements.

*Resources* correspond to the asset side of a balance sheet in a traditional financial statement. The items presented to the table are a list of Systematic's human resources that are available to achieve its goals. The total numbers of employees are listed. Job functions, qualifications, educational level and certifications are described. The information is presented over a five-year period in order to allow for comparison over time. The level of "software competency" is presented as the accumulated number of years that the workforce has spent working in the field.

**Table 4: Systematic human resources**

Resources	97	98	99	00	01
Recruitment:					
Number of employees in Denmark	98	124	137	139	187
Number of software engineers	49	90	103	112	154
New software engineers	22	32	29	26	60
Prof. software competency (total years)	342	485	534	574	775
Prof. software competency per software engineer	4.8	5	5.2	5.5	5.6
Bachelors, masters and PhDs (%)		66	69		61
Number of certified employees:					
Microsoft					
• Professional				31	71
• Solution developer				0	9
Sun Microsyst.					
• Java Programmer				22	63
• Java Developer				0	5
Oracle					
• Database Adm.				2	5
• Developer				4	8

Source: DATI, Analysing Intellectual Capital Statements

*Activities* are initiatives designed to enhance the intellectual capital of Systematic's workforce. Systematic's statements report on the number of training days per employee per year and provide a monetary figure for training expenditure per employee.

**Table 5: Sytematic's human capital activities**

Activities	97	98	99	00	01
Development:					
Course days per employee	3.6	5.2	7.8	6.4	8.5
Investment in education per employee in thousand DKK	11	10	20	11	13.5

Source: DATI, Analysing Intellectual Capital Statements

*Effects* are described to assist in determining the impact of Systematic's intellectual capital efforts on the workforce. *Effects* are measured in terms of employee satisfaction, employee loyalty, unsolicited job applications, absenteeism, and perceptions of the desirability of Systematic as an employer, and software engineer turnover.

**Table 6: Systematic's human resource effects**

Effects	97	98	99	00	01
Satisfaction with:					
• Culture	3,9	3,8	4,0		
• Immediate superiors	3,3	3,4	3,6	3,5	3,6
• Assignments	3,6	3,7	3,6		
• Top management	3,4	3,5	3,6		
• Management values				3,8	3,9
• Employee conditions and development				3,7	3,9
Employee loyalty				4,1	4,2
Number of unsolicited job applications			59		
Sickness absence	3,4	4,0	3,8	3,8	4,9
Total satisfaction with development opportunities	3,6	3,7	3,7	3,8	4,0
Proportion of employees considering SSE as a good/very good workplace	88	93	95	89	93
Loss of software engineers	8	11	16	21	18

Source: DATI, Analysing Intellectual Capital Statements

Precisely how *resources* and *activities* work together to create *effects* is unclear. In each of the reporting areas, the information needs to be put into a context before it becomes useful to readers.

There are other limitations. The report notes that the qualitative assessments of the intellectual capital statements cannot be converted into a forecast of future growth and profitability, and adds that no general relationship between non-financial information and financial results has been documented. It cites both positive and negative relationships between, for example, employee or customer satisfaction and financial results and notes that it is entirely possible to have satisfied employees and happy customers without earning money. As a consequence, the interrelationships between resources, activities, effects and financial performance can be expected to vary from company to company. It is also unclear how effects such as employee satisfaction and loyalty, or the number of unsolicited job applications ultimately affect traditional financial performance indicators such as profits or cash flow. This is left to the analyst to decide.

Nevertheless, the information provides some valuable insights. For one, the company is growing. It is able to attract and retain key human talent in the form of software engineers. On the client front, it is less exposed to single clients—thus presumably reducing its risk.

Finally, the report suggests that a conceptual framework for intellectual capital reporting is needed. Under the present DATI guideline, companies decide what figures they want to disclose and choose the story that they want to tell. There is no requirement that both the good and the bad be disclosed, and there is no developed concept for intangible liabilities. Nor are there any core items that all companies need to report. Each of these factors might cause investors to question the credibility of intellectual capital statements.

In summary, an analysis based on DATI intellectual capital statements can yield insights that are of real interest to investors. However, there are limitations to these statements; it is difficult to link measures

to financial performance; users might find themselves much more reliant on a qualitative discussion of factors, and; comparison is difficult because of the idiosyncratic nature of intellectual capital.

*(c) The Wissensbilanz in Germany*

The Wissensbilanz<sup>89</sup> project has resulted in the implementation of intellectual capital statements and of knowledge management systems in a number of small and medium-sized enterprises (SMEs). The impetus behind the project, which was sponsored by the Federal Ministry of Economic and Labour, was to protect and enhance the competitiveness of Germany's Mittelstand (the SMEs that are the source of much German productivity) in the face of increased competition. According to the guidelines "The future of Germany as an industrial location can only be safeguarded in the face of international competition by ensuring high-quality work and innovation."<sup>90</sup>

The key motivation for the project was to reduce the cost of capital for Mittelstand companies that rely primarily on bank lending for their capital. The promise of the Wissensbilanz project was to reduce the cost of borrowing for innovative and risk-prone investments by offering banks and investors better information for their decision-making by allowing SMEs the opportunity to report intangible assets as a component of their value.

The Wissensbilanz project also aimed to address the impact of the Basel II accord on SMEs in Germany. Basel II (promulgated by the Basel Committee) aims to make the international financial system safer by reflecting the riskiness of bank loan portfolios in the capital charges banks set aside for unexpected losses. For many reasons that are only partially linked to the new Basel II agreement, German banks had changed their lending behaviour and were paying more attention to the riskiness of their clients. Riskier SMEs were facing higher interest rates and higher collateral requirements. The Wissensbilanz project estimates that SMEs that can show that they have a lower risk because of their intellectual capital can expect to benefit from lower interest rates and better access to loans.

With these rationales and objectives in mind, the guideline offers practical help. Most of the guideline is taken up by detailed case studies that are designed to help the reader implement an intellectual capital management system and develop intellectual capital reports.

A typical Wissensbilanz covers a large number of factors including human, structural and relational capital. Companies are directed to go through an initial brainstorming session to identify the factors which have the greatest influence on the production process and the greatest impact on business success. Excerpted in Box 12 below, are some of the human capital-related questions that are suggested for management to consider:

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<sup>89</sup> The literal translation would be Knowledge Balance Sheet, though intellectual capital statement will be used interchangeably with the term Wissensbilanz in this report.

<sup>90</sup> German Federal Ministry of Economics and Labour (2004), Intellectual Capital Statement - Made in Germany, Guideline 1.0 on the preparation of an intellectual capital statement (2004).

### Box 12: Key questions to begin an analysis of human capital

In the area of human capital, key questions are:

- ┆ How are suitable employees found, recruited and retained?
- ┆ How are employees trained and given further skills?
- ┆ How are the competencies and skills of employees systematically strengthened and refined?
- ┆ How is employee motivation and satisfaction ensured?
- ┆ How is employee performance promoted and challenged?

Source: Intellectual Capital Statement - Made in Germany, Guideline 1.0

The result of the process of questioning and examination is a statement that reflects the specificities of each enterprise. An excerpt of the human capital and relational capital indicators from an intellectual capital statement of the Seibersdorf Austrian Research Centre are illustrated in Table 7 below.

**Table 7: Intellectual capital statement of the Seibersdorf Austrian Research Centre**

Human capital	2002	2003	Evaluation	Goal
Academics		21	☹	
Specialists		8		
Unskilled workers (uncompleted studies)		4		
Apprentices		3		
Trainees		0		
Acceptance rate of apprentices, interns and trainees		33 %		
Per capita further training costs (external)		1.014 €	☹	↗
Further training days per employee (external)	2,6	3,3	☹	↗
<b>Building up employee experience</b>				
Experience in years		4,7	☹	↗
Experience in years not incl. apprentices		6,2		
<b>Building up social competence</b>				
Estimation of the customers				
<b>Motivating employees and building up leadership competence</b>				
Index of employee questionnaire		0,61	☹	↗
Employee fluctuation (in and out)		0,31		
Absenteeism	5,6	5,7	☹	

Source: Intellectual Capital Statement - Made in Germany, Guideline 1.0

The table above shows indicators for factors such as training expenditures, employee experience and motivation. These factors receive numerical valuations that allow for comparison over time. The use of the indicators is designed to provide companies with an insight into the intellectual capital that is relevant to competition and what could be done to manage these factors better.

The guideline distinguishes clearly between internal and external reporting. The former is more detailed and task specific, the latter more focused on outcomes and different stakeholder information needs. As with the DATI project, the guidelines were tested on real companies. Intellectual capital statements were developed for a number of small and medium-sized enterprises with the support of the Federal Ministry of Economics and Labour.

Overall, companies that participated in the testing expressed satisfaction with the experience. The implementation of an intellectual capital statement was perceived by all participating organisations as a positive contribution to their competitiveness and the development of the organisation. All of the enterprises involved reported benefits from the implementation of an intellectual capital statement that emanated from new perspectives on the value of intellectual capital and the importance of its management.

***(d) Guidelines for Disclosure of Intellectual Assets in Japan***

The Guidelines for Disclosure of Intellectual Assets in Japan<sup>91</sup> were compiled by the Ministry of Economy, Trade and Industry (METI) to help corporations put together intellectual capital statements.<sup>92</sup> The objectives of the project were to: 1) produce “sustainable profits” and enhance “corporate value” to stakeholders, and; 2) share a sense of value with stakeholders. The guidelines describe the disclosure process as a management method designed to enhance corporate value from the perspective of multiple stakeholders. The ultimate promise is to optimise the allocation of management resources for the whole economy. The guidelines also seek to address the issue of corporate short-termism caused by modern reporting. They suggest that it may be necessary to emphasise “mid-term corporate value and the possibility of sustainable profits” as opposed to “near-term items directly linked to profits”.

The guidelines provide detailed descriptions of how intellectual capital statements could be drawn up. The basic structure of a report is described in Box 13, below.

**Box 13: Structure of an intellectual capital report according to the Japanese guidelines**

<p><b>General:</b></p> <p>Basic management philosophy</p> <p>Outline of business characteristics</p> <p><b>From Past to Present:</b></p> <p>A: Management policy in the past</p> <p>B: Investment including performance figures</p> <p>C: Unique intellectual assets accumulated in the company, strengths based on them, and value creation method</p> <p>D: Actual performance in the past, such as profits</p> <p><b>From Present to Future:</b></p> <p>E: Intellectual assets that will be effective in the future, and future value creation method based on them</p> <p>F: Identification of future uncertainty/risks, how to deal with them, and the future management policy including those elements</p> <p>G: New/Additional investment for maintenance and development of intellectual assets</p> <p>H: Expected future profits, etc.</p> <p>Other intellectual assets indicators (optional)</p>
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Source: Ministry of Economy, Trade and Industry (2005), Guidelines for Disclosure of Intellectual Assets Based Management

<sup>91</sup> Guidelines for Disclosure of Intellectual Assets-Based Management, Ministry of Economy, Trade and Industry, October 2005.

<sup>92</sup> See the related Interim Report (2005) of the Subcommittee on Management & Intellectual Assets, New Growth Policy Committee, Industrial Structure Council, in this report.

Under the guideline, the structure of an intellectual capital report has three components which can be summarised as: 1) descriptive; 2) backwards-looking historical information, and; 3) future-looking. Reports may be produced as free standing items or be a part of existing documents such as annual or sustainability reports.

The guidelines also provide examples of key performance indicators (KPIs) that it suggests are important to developing the “story” that the enterprise wishes to tell and to enhance the credibility of statements. Some of the performance indicators related to human capital are summarised in Box 14, below.

**Box 14: Selected performance indicators that deal with human capital**

<p><b>(1) Management stance/ Leadership</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> (Indicator 1-1) Degree of internal penetration of management principles</li> </ul> <p><b>(2) Selection and concentration</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> (Indicator 2-6) Employee assessment</li> </ul> <p><b>(4) Knowledge creation/ innovation/ speed</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> (Indicator 4-4) Employees' average age and increase/decrease from the previous year</li> </ul> <p><b>(5) Teamwork/ organizational knowledge</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> (Indicator 5-1) In-house improvement proposal for quality control system, number of proposals and improvements achieved</li> <li><input type="checkbox"/> (Indicator 5-2) Number of lateral projects</li> <li><input type="checkbox"/> (Indicator 5-3) Degree of employees' satisfaction</li> <li><input type="checkbox"/> (Indicator 5-4) Incentive system (including yearly contract system)</li> <li><input type="checkbox"/> (Indicator 5-5) Job leaving ratio</li> </ul>
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Note: Only the categories with some human capital component are reproduced here. There are others that cover a larger set of intangible assets.

Source: Ministry of Economy, Trade and Industry (2005), Guidelines for Disclosure of Intellectual Assets Based Management

These general indicators are described in detail in the guidelines and, in some cases, mathematical formulas are provided for calculating them. The formulas should, in principle, permit comparison of indicators between companies.

The guidelines—like that of those of the Danish Agency for Trade and Industry—include guidance to assist analysts and stakeholders in interpreting the new statements. They warn that it is necessary for users to interpret the resulting reports differently from conventional financial statements.

***(e) The Enhanced Business Reporting Consortium 360° in the US***

The Enhanced Business Reporting Consortium (EBRC)<sup>93</sup> is an international collaboration of investors, creditors, analysts, management, boards of directors, regulatory agencies, standards setters, members of academia and other stakeholders that has set as its objective the development of guidelines for better reporting. It was principally founded by the American Institute of Certified Public Accountants (AICPA) Center for Public Company Audit Firms, two accountancy firms (Grant Thornton, PricewaterhouseCoopers) and Microsoft Corporation. The EBRC is intended to be a collaborative project

<sup>93</sup> For more information see: <http://www.ebr360.org/Default.aspx>.

between users and suppliers of capital to improve the quality of reporting for the capital markets. The grouping is intended to be both independent and market-driven in its projects.

The themes that the EBRC has chosen to address are consistent with the other initiatives described in this section of the report, though it has a broader and more business-oriented agenda. In addition to trying to improve reporting on value creation, it aims to assist in the elimination of complex, superfluous and multiple disclosures that are costly for corporations and confusing for users. It also seeks to make information easier to use. In this respect it has committed to making its reporting framework compatible with XBRL taxonomies (See the section on technology and XBRL below) in order to simplify reporting and reduce reporting costs.

At the time of writing, the consortium had not produced any specific guidance on intangibles reporting. Nevertheless, it is clearly its intention to do so. Its ultimate goal would be to develop a voluntary framework for the presentation and disclosure of value drivers, non-financial performance measures and qualitative information. The purpose of providing this information is to clarify corporate strategy and to strengthen the capital markets. The project is inclusive of other stakeholder groups but does not focus on them.

Some of the non-financial information that the EBRC framework would cover includes items such as product innovation, people issues and customer loyalty and many others that are cited in the intangibles literature. Such information would serve to provide a more complete and balanced picture of companies, in particular of companies that rely heavily on intangible assets for their performance and success.

The consortium foresees a number of benefits for: 1) management; 2) corporate governance, and; 3) the financial markets. Better information for company management should enhance their decision-making ability and performance. For corporate governors, better information should allow directors to better fulfil their fiduciary responsibilities to shareholders. The capital markets should be able to make better investment decisions, which would lead to better capital allocation within the economy and a lower cost of capital for companies. Some of the more specific benefits that the EBRC sees for the financial markets are: 1) A decline in the over-emphasis on quarterly earnings; 2) a more balanced and complete view of company performance; 3) better decisions by management due to stronger oversight and market discipline, and; 4) reduced uncertainty and market volatility because of lower information risk.

The EBRC, like other groups, estimates that the benefits of better reporting far outweigh the costs. In its discussion of costs, it suggests that the costs of not solving reporting problems exceed the costs of action. The ultimate cost, it argues, would be the failure to restore confidence and trust in the financial markets that were shaken by accounting and governance scandals.

It also suggests that some of the costs typically associated with better disclosure may be exaggerated. The example that is cited regards the disclosure of competitive information. The EBRC cites work that suggests that most of the intelligence that companies wish to hide from their competitors is already available to them by other means. Another cost frequently cited in the US is that of litigation. The EBRC argues that litigation risk should be self-mitigating; if a company is truly transparent and acts in good faith, it will not deliberately make false or misleading statements and should thus be shielded from litigation. It concedes that this is a gray area where safe harbour legislation may be required to encourage corporate transparency.<sup>94</sup>

In summary, the EBRC has objectives that are largely congruent with the other initiatives described in this report. It differs in that its strategy is more clearly consistent with a voluntary, market-driven approach.

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<sup>94</sup> See below for a brief discussion of safe harbours.

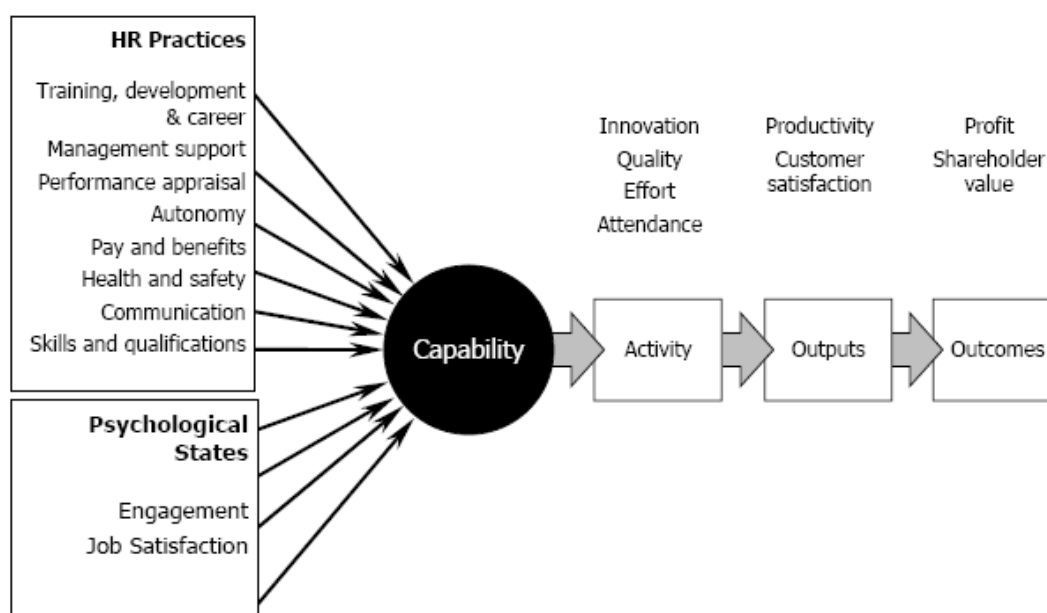
Its focus is also more directed at the information needs of the capital markets. Its website suggests that the most difficult aspect of its task will be to persuade corporate America that greater transparency brings real benefits for companies and investors.

**(f) The Institute for Employment Studies Report in the UK**

In 2005, the Institute for Employment Studies (IES)<sup>95</sup> finalised its report entitled *Measuring the Contribution of Skills to Business Performance*.<sup>96</sup> The report was published by the UK Department for Education and Skills. It differs from the other reports and guidelines described in this section by focusing specifically on human capital. The IES study identifies human capital measures that are empirically associated with business success, and links them to hard outcomes.

The study provides a framework for understanding and describing the causes and effects between human capital and the bottom line. Graphic 4 below illustrates the causal effect of the most relevant human resource practices and “psychological states” (which combine to create what is referred to as human resource capability) on corporate activities (such as innovation, effort, and attendance), which, in turn, affect specific outputs (such as customer satisfaction and productivity), which ultimately affect financial outcomes (profits and shareholder value).

**Graphic 4: The chain of impact: from human resource practices to profits and shareholder value**



Source: *Measuring the Contribution of Skills to Business Performance*, Institute for Employment Studies

While other models describe the impact of human capital on specific elements of corporate operations, the IES model centres its approach on final outcomes and what is of ultimate interest to

<sup>95</sup> IES is an independent, apolitical, international centre of research and consultancy in human resource issues. It works closely with employers in the manufacturing, service and public sectors, government departments, agencies, and professional and employee bodies.

<sup>96</sup> Tamkin, Penny (2005), *Measuring the Contribution of Skills to Business Performance*, Institute for Employment Studies. The report can be downloaded from the website of the UK Department for Education and Skills: <http://www.dfes.gov.uk/>

businesses and the financial markets. IES thus provides a “pole star” which serves to guide both the analysis of human intangibles and the actions of management.

The study identifies measures that can be integrated logically into the regular planning and financial reporting processes of corporations. It also seeks to integrate into its own model measures identified by other existing models of human capital management.<sup>97</sup> Each of these measures is slotted into a framework which is referred to as the 4A Model. The four A’s stand for *access*, *ability*, *attitude* and *application* and are defined as follows:

1. *Access*: the effective resourcing of roles in the organisation
2. *Ability*: the skills of the workforce
3. *Attitude*: the engagement, motivation and morale of the workforce
4. *Application*: the opportunities available to ensure skills and motivation are effectively applied.

*Ability* and *attitude* are factors contributed by human resources. *Access* and *application* are factors determined by the corporation. Human contributions may include such factors as skills and enthusiasm. The corporation provides the organisational context in which the human resources operate. Corporate factors may include the provision of financial resources and tangible assets, operating procedures, job design, etc. Combined, access, ability, attitude and application determine the company’s human resource capability. Each of the four areas has a number of core measures, which are summarised in Box 15 below.<sup>98</sup>

**Box 15: Core measures of human resource capability under the IES 4A Model**

**1) Access:** Access covers factors such as the resourcing and succession strategy, process and practice of the organisation. How people are attracted and selected for the organisation, both at entry and at promotion points.

**Core Measures:**

- number/proportion of vacancies/posts filled internally
- number/proportion of jobs subject to test on recruitment
- number/proportion of new recruits fully experienced on appointment (average)
- proportion of vacancies for which there exists a specification detailing skills needed for the role.

<sup>97</sup> The IES framework was tested against numerous models to ensure that it covered relevant measures: Models by policy bodies included: the UK Department of Trade and Industry–Benchmark Plus; the Council for Excellence in Management and Leadership (CEML); the Chartered Institute of Personnel and Development CIPD. Private models included: Bassi, McGraw and McMurrer, the Human Capital Index by Watson Wyatt Worldwide, 2002, The Organisational Performance Model from Mercer HR consulting. Academic approaches included: Kaplan and Norton 1996, 2004, the HR scorecard by Becker B, Huselid M, Guest, 2000, Thompson, 2000, Pfeffer, 1998, Pil and MacDuffie, Ashton and Sung, 2002, and Sung and Ashton, 2005.

<sup>98</sup> The report contains additional indicators which are considered desirable. However, the box shows only core indicators for the sake of brevity. For a complete listing of measures and a full discussion of the rationale for their inclusion, the original document should be consulted. It can be downloaded from the web site of the UK Department for Education and Skills: <http://www.dfes.gov.uk/>.

**2) Ability:** Ability covers the skills and competencies of the workforce. It also captures the activity taking place to grow this capability through training and development. Ability is divided into two elements: “activity” which generates ability and “stock” which is an indicator of existing abilities.

**Core Measures:**

*Activity:*

- how many/proportion of workforce receiving training
- total training days per annum (per non-managerial employees)
- training expenditure per annum (spend per non-managerial employee)
- management training days per annum (per manager)
- expenditure on management training per annum (spend per manager)
- proportion of the workforce with current PDP or development objectives.

*Stock:*

- number/proportion of non-managerial employees with degrees/degree level.
- number/proportion of managers with degrees/degree level.
- proportion of workforce with formal qualifications to level minimum.
- proportion of managers who are fully proficient.
- proportion of key workforce group who are fully proficient

**3) Attitude:** Attitude captures the motivational wellbeing of the workforce. It includes the effort people put into work and the pride and quality of what they do. It captures the motivation, morale and engagement of the workforce and all the policies and practices which are designed to help engage people better.

**Core Measures:**

- numbers/proportions of lay-offs in last two years
- proportion of the workforce receiving profit related bonus or share options
- percentage of pay that is variable
- percentage receiving performance pay
- percentage receiving appraisals
- frequency of regular, formal and private discussion between an individual and their line manager
- absenteeism (total hours lost to sickness per/total available hours)
- Bradford factor = (number of incidences of absence)<sup>2</sup> × total number of days lost
- Turnover — number of voluntary leavers in year / total workforce numbers.

**4) Application:** Application comprises the ways in which organisations provide opportunity for people to apply their skills and enthusiasm at work. This opportunity can be through the design of jobs people do, the resources they have at their disposal, through the culture of an organisation and the degree to which it encourages involvement and autonomy.

**Core measures:**

- IT spend as a percentage of total turnover
- existence of formal process for employee involvement

- proportion of workforce participating in:
  - team briefing
  - suggestion schemes
  - quality circles
  - regular face to face meetings with managers
  - upward appraisal
  - receiving organisation wide newsletter
  - regular staff survey
- frequency of meetings per annum with staff representatives to discuss employee matters
- percentage of workforce multi-skilled *i.e.* can do range of different jobs or perform range of job roles.

Source: Condensed and adapted from Measuring the Contribution of Skills to Business Performance, Institute for Employment Studies.

There is, of course, room for discussion of what measures should be included and excluded, and precisely how these measures should be categorised. This and the practical application of these measures in business need further testing and development.

The IES report is an important addition to the effort to categorise and measure intangible values. It focuses specifically on human capital and places human capital in the context of profits and shareholder value. The indicators that are used are selected to have a causal—even if indirect—link to value creation. The model will most likely be useful for management in developing human resource policies based on tested measures that are linked to hard business objectives. It could also be an attractive model for capital markets reporting since it focuses principally on the outcomes which interest investors.

\* \* \* \* \*

To summarise this section of the report, new reporting models are evolving. MERITUM and DATI provide general approaches to the management of intangible assets in companies and some indication of the form that intangibles reporting might take. Neither provides specific guidance on human resource related measures or how to deal with the specificities of human resource management and reporting. IES provides far greater detail and useful guidance in this area while remaining centred on the issue of profit and value creation, which is the fundamental concern of both companies and the financial markets. Further work needs to be done before intangibles and specifically human resource reporting generate comparable and credible statements similar to what one might expect in the financial area.

All of the initiatives are similar in their recognition of an intangibles gap. They differ, however, in their assessment of the problem and in the solutions they propose. The Japanese context, for example, is one of revitalizing companies, whereas in the US it is one of re-establishing confidence and trust in the financial markets. In Europe there is concern regarding the competitiveness of companies, in particular, SMEs.

The solutions differ too. There is more appetite for regulatory intervention and for government direction in both Japan and Europe. There is greater reticence in the US where the EBRC focuses on voluntary approaches and commits itself to being market-driven. The picture is arguably mixed in the UK.

The differences, should, however, not be exaggerated since all countries have important initiatives aimed at closing the disclosure gap through the development of a strengthened reporting framework.

### 5) The role of technology: XBRL and the future of reporting

Technology is having an impact on reporting. In many countries, regulatory filings can now be done electronically, corporate information can be accessed via the Internet, and information can be copied and distributed at far less than the cost of printing. While technology has not resulted in a paperless society or had the impact on expenses that some had hoped, it has improved the timeliness and ease of reporting. This section of the report is devoted to XBRL,<sup>99</sup> which can be anticipated to have a profound impact on reporting in the future.

XBRL or Extensible Business Reporting Language is an outgrowth of web technology. The XBRL consortium that oversees its development is a collaborative international effort that began in 1998. Members of the consortium include professional services and consulting companies, financial services and information providers, software and other technology providers, government and not-for-profit organisations, and accounting and trade organisations.

The description of how XBRL works provided on the XBRL International website is reproduced in Box 16 below.

#### Box 16: XBRL: How it works

Instead of treating financial information as a block (an annual report or a balance sheet) it allows users to look at the individual components of the block (for example, net profit). Each component has a unique identifying tag. This tag functions similarly to a "bar code" on items that one might purchase in a supermarket.

Users can download information from computers manipulate it and compare it as they wish. Analysts may use proprietary analytical techniques. The result is that companies can use XBRL to save costs and streamline their processes for collecting and reporting financial information. Consumers of financial data, including investors, analysts, financial institutions and regulators, can receive, find, compare and analyse data much more rapidly and efficiently if it is in XBRL format. XBRL can handle data in different languages and accounting standards. It can flexibly be adapted to meet different requirements and uses.

Source: Website of XBRL International: <http://www.xbrl.org/Home/>

How XBRL works is arguably less important than what it promises to deliver. It allows for instant, low cost electronic reporting and data collection, and allows users to manipulate and analyse data in whatever fashion they see fit. XBRL also holds the promise of a new way of managing information. It should allow for the seamless integration of various phases of the reporting process and the integration of internal and external reporting—processes that were generally conducted separately even if they were based on the same data. One of its greatest potential benefits is flexibility. For example, analysts can download data and analyse it using proprietary algorithms. They can aggregate, disaggregate, manipulate or eliminate data as they wish.

<sup>99</sup> XBRL is an open standard language based on XML that can be incorporated into accounting and analytical software tools and applications. XML, or EXtensible Markup Language is an open standard for describing data from the W3C. It is used for defining data elements on a Web page and business-to-business documents. W3C, or the World Wide Web Consortium is an international industry consortium that develops standards for the Web. The W3C has standardised many of the fundamental technologies of the Web, including XML, HTML, and URLs.

In order for XBRL to function it requires the presence of an underlying standard to define what data means. This is referred to by the consortium as a taxonomy. At present taxonomies exist for US GAAP, IFRS and other standards.<sup>100</sup> The only pre-requisite is that taxonomies (in order to be useful) need to be developed based on generally accepted standards. In principle taxonomies can be developed for intellectual capital and human capital reporting, however, a generally accepted standard has yet to emerge.<sup>101</sup>

The future may nevertheless be visible. It is entirely conceivable that should a consensus emerge around a robust standard on intellectual capital that it could serve as the basis of an XBRL taxonomy and allow for the reporting, retrieval and manipulation of human capital information. Some existing models such as, for example, the French Bilan Social, which contains a specific list of reporting requirements, would be suitable as an XBRL taxonomy in their present form with little or no adaptation.

Box 17, below, shows that XBRL is a growing international phenomenon that is finding considerable interest from regulators.

**Box 17: Recent country policy initiatives regarding XBRL**

**In China** more than 800 companies filed their 2005 half-year reports in XBRL using taxonomies developed by the Shanghai Stock Exchange.

**In Europe** the Committee of European Banking Supervisors (CEBS) has announced support for XBRL and is building a taxonomy with XBRL members, including the Bank of Spain, to handle solvency ratio reporting.

**In Ireland** the Central Statistics Office piloted the use of XBRL in its industry surveys, creating the first live implementation of XBRL in Ireland.

**In Japan**, the Bank of Japan will adopt XBRL for inspecting financial institutions, perhaps as early as next year. Japan's Financial Services Agency also said it will introduce the use of XBRL for financial statements by fiscal 2008. Japan has also published the XBRL specification as an official industrial standard, providing a basis for government departments and other authoritative organizations to adopt XBRL.

**South Korea's** financial supervisor will adopt the use of XBRL for companies' financial reports.

**In Spain** the Spanish Stock Exchange has begun to use XBRL for receiving and distributing public financial reports from more than 3 000 listed companies. The Bank of Spain is receiving regulatory data in XBRL from banks covering some 80 pct of the Spanish market. The Bank of Spain has also developed a Financial Information Exchange System to support XBRL reporting by credit institutions.

**In the UK** the government has announced a plan to enable filing of Corporation Tax using XBRL in 2006.

**In the US** the Federal Deposit Insurance Corporation began receiving quarterly bank information using XBRL where analysts can now access information in a matter of seconds rather than hours or days.

**Internationally**, the OECD Tax Payer Services group has recommended XBRL as a central standard for exchange of business and financial information for tax purposes.

Source: Website of XBRL International: <http://www.xbrl.org/Home/>

<sup>100</sup> XBRL is equally useable for non-financial information as numerical data. Taxonomies have already been developed for US MD&As.

<sup>101</sup> Kurt Ramin, President of the XBRL consortium has encouraged the development of an internationally accepted standard for intangibles reporting, and indicated that an XBRL taxonomy could easily be developed.

Clearly XBRL technology speaks to some of the key goals of regulators such as improved filing and information dissemination. In principle, it holds the potential for a bonanza for analysts and statisticians if all company data were thrown open to the world. However, greater access can have drawbacks. One is that providing too much information can damage a company's competitive position. For example, information on the size of investments in certain product lines, would give competitors an unprecedented and unwarranted insight into company strategy.

Technology has the power to transform traditional approaches and ways of thinking and XBRL has clear implications for intellectual capital reporting. Intellectual capital reporting by XBRL could be enormously useful, but standards need to be agreed first in order to develop XBRL taxonomies.<sup>102</sup>

## 6) Summary and conclusions

Unlike some studies which suggest that little has occurred in recent years in the field of intangibles disclosure, this report finds considerable activity in research, regulation and accounting standard setting. There is more consensus on the need for improved reporting than ever before, and there are clearer strategies for how to address some of the technical problems. Intangibles are no longer viewed as a mere accounting residual, but an important area of disclosure that holds the potential for considerable economic benefits.

The gaps in traditional accounting have been recognised by the accounting community who are working on fixing them. Some intangibles are easier to reflect in financial statements than others. R&D, software and patents are assets which fit more easily into the existing accounting model. Human capital has the distinction of being the most difficult item to incorporate in financial statements.

Change is slow, and this has led to frustration that has resulted in calls for greater regulatory intervention in the accounting standard setting process. Ultimately, the extent to which financial statements reflect different types of intangibles is determined by conceptual frameworks and by the due process requirements of accounting standard setters. Frameworks and due process contribute to the strength and utility of accounting standards.

Support from traditional users of financial information for more human capital information has been tepid. Support for capitalisation of human capital expenses has been overtly negative. The potential danger of recognition and capitalisation is that they can be used to inflate balance sheets and, if not applied uniformly across enterprises, may degrade the comparability of financial statements. There is also the threat that the opportunity to put more intangible assets on balance sheets will lead to accounting shenanigans.

In any event, human capital will not likely be reflected on balance sheets in the near future. The solution to the intangibles gap lies in supplementary disclosure, in particular in director's reports or MD&A disclosure. MD&As appear to be better suited for reporting information where judgment is required and where the standard of proof is lower than in accounting. All of the countries reviewed for this report encourage such disclosure and make explicit mention of the importance of employees in adequately describing firm performance.

Another possibility for better human capital reporting comes from breaking out training and other costs by disaggregating data. Disaggregation can provide much valuable information and does not require fundamental changes to the accounting model. What the limits of disaggregation are, what information is truly useful, and competitive concerns need to be explored.

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<sup>102</sup> Kurt Ramin, Chairman XBRL International.

Radical change to accounting standards is not viewed as a realistic approach. As a result, new approaches to reporting and supplemental statements stand to contribute more to the information needs of users. Governance, environmental, social and human capital statements are examples of supplemental reporting. Each provides important information that traditional financial statements cannot capture. The future of reporting will be one in which there is a number of reports. Traditional statements will continue to have great relevance, though they will increasingly become one element in a broader set of disclosures.

New reporting has made striking advances. New reporting models allow users to focus on specific areas of interest such as human capital and not just intangible assets in general. CSR and environmental reporting have become more broadly accepted by the capital markets as awareness of the related risks grows. Human capital reporting is also becoming increasingly sophisticated with increasingly sophisticated attempts to link measures to financial performance.

Some of the problems with the new reporting is that intangibles are idiosyncratic. Much intangible information is company, industry or function specific. While flexibility and adaptability of reporting may suit company needs, users need to have comparability. Intangibles reporting will benefit from the comparability that rules and a conceptual framework can provide, in the same way that the conceptual framework provides a sound basis for financial accounting.

The costs of additional disclosure are seldom given the consideration they deserve. While costs are discussed everywhere, they are rarely quantified and the benefits of reporting are not generally subject to quantification. Demands for new reporting often meet with stiff resistance from business and in some cases policy makers because of the costs. Businesses face unremitting pressure to reduce them. There will be increasing calls to demonstrate that the benefits of new reporting outweigh the costs, especially in the wake of the rejection of the OFR in the UK. Another key concern is the utility of information. More data is not always better; it can be just more data.

There is broad agreement on the importance of intangibles in a modern economy. There are also good arguments that support the notion that reporting needs to improve and that financial market function could be improved. Yet, countries can be expected to respond differently based upon their regulatory culture. To date, there have been more calls for regulatory intervention and mandatory disclosure in European countries and less in the US. This is unsurprising. Some countries are willingly to do more to encourage disclosure and others want “not just a light touch but a limited touch”.<sup>103</sup> A “one size fits all” approach is not feasible with intangibles.

As in other areas, technology has the potential to revolutionise. XBRL is not just a rapid method of filing. XBRL can significantly reduce the cost of reporting and has the potential of providing highly tailored information to a broad variety of users. There is not only increasing interest in XBRL but also greater use. The usage of XBRL for non-financial reporting, intangibles reporting and human capital reporting should be explored and encouraged.

Intangible assets disclosure is often linked to CSR and sustainability reporting. This linkage causes discomfort for some businesses and analysts who see social reporting as drawing attention away from core business objectives. They see some new reporting as an attempt to hold businesses accountable to a new set of rules and norms. The linkage between social and financial reporting has, at times, politicised the intangibles debate.

The arguments for both CSR and market-driven human capital reporting are compelling. However, countries should distinguish between CSR and market-driven reporting. Though there may be some

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<sup>103</sup> The Rt. Hon. Gordon Brown (See Section on the OFR above).

overlap, they serve different users and fulfil different functions. For the moment, distinguishing clearly between users and different user needs, and answering the “so what”<sup>104</sup> of reporting are fundamental to finding support for new reporting initiatives.

Among the studies and documents reviewed for this report, intangible disclosure is generally placed in the context of strengthening the competitiveness of corporations and national economies. Intangible assets are seen as sources of competitive advantage. Some of the discussion of intangible assets takes place in the context of stemming the onslaught of the forces of globalisation. Greater intangible reporting should not be seen as a way of impeding the function of markets but, rather, a means of enhancing market function.

There has been significant government support of all of the major reporting initiatives cited in this report. Government has a clear role to play in encouraging transparency and disclosure, and it is not at all certain that markets will automatically demand and generate greater transparency. Intangibles reporting needs a strong conceptual framework to improve the comparability, reliability and usefulness of intangibles information to users. Encouragement of such a framework could be a key policy objective.

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<sup>104</sup> The PRISM Report.

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