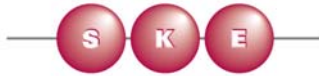




Society for Knowledge Economics




Submission to the Enhanced Business Reporting  
Consortium for the U.S. Security Exchange Commission's  
Advisory Committee on Improving Financial Reporting

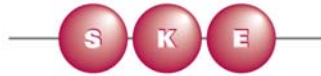
January 25, 2008



## Society for Knowledge Economics

### About the Authors

 <p><b>Christina Boedker</b> Chief Executive Officer, Society for Knowledge Economics, Australia</p>	<p>Christina is the author of the Australian Guiding Principles on Extended Performance Management and has been a Research Advisor to the Society since 2005. Christina has previously held positions as department head in Operations and Marketing and done consulting and research projects with US, Australian and European organisations.</p> <p>Christina was awarded the Emerald Literati Network Award for Excellence in 2006 for her research on intellectual capital. She also holds the Carlson Companies' Award, Saunders Harris' Prize for Outstanding Academic Achievement; the Mindshift Consulting Group Prize; the UK Advertising Standards Authority Award; MGSM's Award for Competitive Intelligence; and MGSM's Award for Human Resources Management.</p> <p>She has published in a variety of accounting and management journals and is a member of the advisory editorial board of the Journal of Human Resources Costing and Accounting, and also previously the Journal of Accounting and Organizational Change. Christina has been Lecturer in Charge of three post-graduate subjects, Managing Intangible Resources, Financial Accounting and Managing Agile Organisations, at UNSW.</p>
 <p><b>Professor James Guthrie</b> Discipline Convener, Accounting, Sydney University, Australia</p>	<p>James Guthrie's research and teaching interests include public sector accounting, auditing, accountability and management, social and environmental reporting and auditing, management of knowledge and intellectual capital and the measurement of intangibles.</p> <p>James has published 122 articles in both international and national refereed and professional journals, and over 34 chapters in books. He has presented his ideas and research findings to 277 national and international gatherings. James is also co-editor of eight public sector management and accounting books</p> <p>James was an Advisor to the Treasurer's Costing Committee leading up to the 2007 government election in Australia.</p> <p>James is a member of the Society for Knowledge Economics and also the Australian Government Consultative Committee on Knowledge Capital.</p>
 <p><b>Professor Jan Mouritsen</b> Department of Operations Management, Copenhagen Business School, Denmark</p>	<p>Jan was the lead researcher on the Danish Intellectual Capital project. Over 100 Danish organisations produced Intellectual Capital statements, the largest IC project ever. The project was sponsored by the Danish Minister of Science, Innovation and Technology. It resulted in the Danish Guideline on Intellectual Capital Statements.</p> <p>Jan's research is oriented towards understanding the role of Management Technologies and Management Control in various organisational and social contexts. He focuses on empirical research and attempts to develop new ways of understanding the role and effects of controls and financial information in organisations and society.</p> <p>Jan is currently an editorial board member of 12 academic journals in various areas of management and business research including accounting, operations management, IT and knowledge management, and has published in a large variety of accounting and business management journals.</p>



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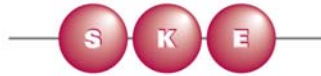
## Background

In August 2007, the U.S. Securities and Exchange Commission established the Advisory Committee on Improvements to Financial Reporting (Pozen Committee)<sup>1</sup>. The Committee's objective is to examine the U.S. financial reporting system and to provide specific recommendations as to how unnecessary complexity in that system could be reduced and be made more useful to investors.

Dr. Bob Eccles, Advisor to the Enhanced Business Reporting Consortium (EBRC), has been invited to present to the Subcommittee on Information Delivery on February 15 in Washington, DC. The Subcommittee will discuss key performance indicators (KPIs) and enhanced business reporting (EBR) for publicly traded corporations.

The Australian Society for Knowledge Economics received an invitation from the President of the Enhanced Business Reporting Consortium, Michael Krzus, to provide an international perspective on EBR.

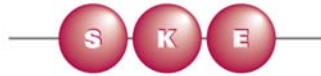
This submission outlines international initiatives and relevant research on intangible assets and intellectual capital, specifically from Europe and Australia. It illustrates, among others, that KPIs and high quality reporting on intangible assets are global issues, not just U.S. concerns.



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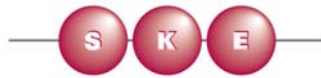


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## Summary of Findings

### **This submission identifies the following trends and issues in enhanced business reporting (EBR) internationally;**

1. There is growing demand for EBR information among business executives and financial markets whose information requirements are changing, reflecting the transitioning from an industrial society to a knowledge intensive, globalised economy;
2. Numerous initiatives have sought to address the changing information requirements of business and financial markets, and internationally, the last decade has seen a proliferation of many different reporting and measurement frameworks and models;
3. Yet, EBR is still in the early stages of its 'lifecycle' and the many (sometimes competing) frameworks offer great diversity in terminologies and reporting practices. Whilst, on the one hand, such diversity can increase 'experimentation' and the uptake of EBR within business, on the other hand, it can also lead to fragmentation and adversely affect information usage, specifically in capital markets. A lack of harmonisation continues to be a barrier to broader uptake and practice.



## Summary of Recommendations

**The submission makes the following four recommendations on how to increase the uptake and practice of EBR in the USA and internationally:**

### **1. International Harmonisation**

The vast diversity in reporting practice indicates a need for harmonisation at an international level. Harmonisation may involve:

- The creation of an international community of practice, which brings together practitioners, policy makers and thought leaders from around the world. Fora, such as the World Intellectual Capital Initiative by the OECD and others, provide one example of an appropriate vehicle for facilitating debates, mediating knowledge and practice, and improving international collaborations and harmonisation.
- The commissioning of larger scale projects where businesses from different countries empirically tests one reporting model over a longer time period (see, for example, the Danish Intellectual Capital project where over 100 companies worked together for 5 years). International collaborations of this kind will aid harmonisation and provide opportunities to bring reporting practices 'closer together'.
- Greater involvement from, and collaboration between, standard setters, such as the International Accounting Standards Board, the US SEC, the European, Australian and Japanese ministries and policy makers, etc.

### **2. Accounting Technology**

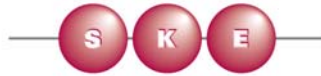
The vast diversity in measurement and reporting models also suggest the need for consolidation and simplification of EBR techniques.

Flexible accounting technologies, such as XBRL, provide an opportunity to do so. XBRL is a flexible technology, which introduces consistency in reporting format and content, yet also allows enough flexibility to accommodate diversity. It benefits business by simplifying and streamlining reporting practices.

A common technology will also help improve information comparability and consistency, and thus assist information users (specifically those in capital markets) better absorb, analyse and incorporate EBR information in their investment decision making processes.

### **3. Practical Experimentation**

Whilst experimentation with EBR has been on the increase in Europe, Japan and Australia, limited practical insights have been derived from US companies. In this regard, it is refreshing to see initiatives such as the Enhanced Business Reporting Consortium gain traction and strength in the US. Indeed, the EBRC may be a suitable body for increasing practical experimentation with American businesses.



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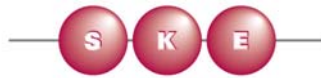
EBRC could, for example, host collaborative projects with US businesses to test the practical use and effects of new accounting technologies, such as XBRL. Diverse stakeholders (such as US financial analysts, chartered accounts, policy makers and researchers) can be brought together to collectively examine what works in practice and also to develop credible criteria for what good accounting of intangibles will look like (i.e. criteria such as reliability, objectivity, identifiable etc).

Collaborative projects can also provide more empirical insights into the cost and benefits of EBR to business and others, and bring forth more evidence to support investments into EBR and the development and measurement of intangibles as strategic resources.

### **4. Education**

Greater visibility into EBR ('what it is' and 'how to do it') is required to increase practical uptake and the broader knowledge base and awareness of EBR in the community.

Inclusion of curriculum on EBR and intangibles in management education programs (i.e. MBAs, financial analysis and chartered accounts) can help improve awareness and practice. Curriculum can focus on business innovation more broadly and also, more specifically, on how to measure, manage and report on business performance in a knowledge based economy.



## 1. Growing Demand for Enhanced Business Reporting Information among Business Executives and Financial Markets

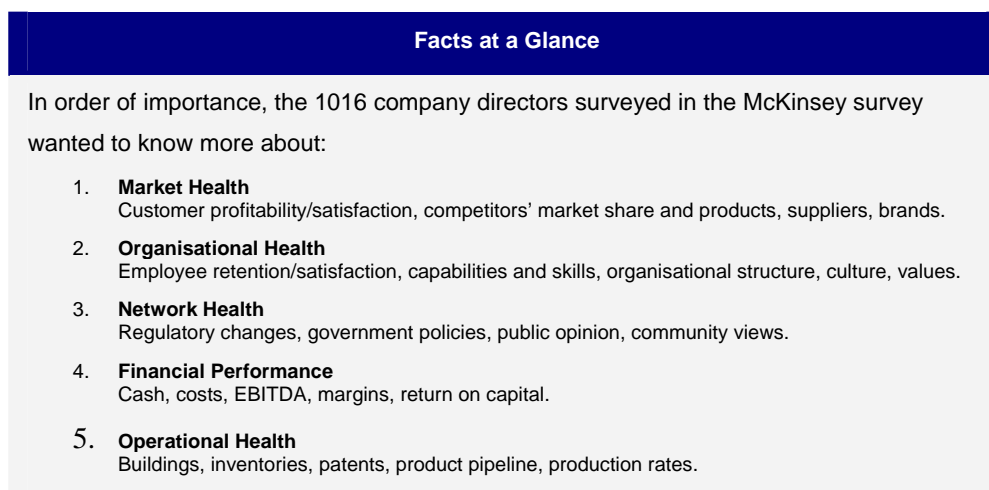
The information needs of business executives and financial markets are changing, and demand for EBR information is increasing. The changing information requirements are reflecting broader economic transformations and the transitioning from an industrial society to a knowledge intensive, globalised economy where intangible resources increasingly drive wealth creation and economic growth.

A survey of 1016 company directors by McKinsey Consulting (2005) illustrates the shift in company directors' information requirements (Figure 1). The survey finds that company directors are looking for more information about intangible resources, such as customer relations, employee satisfaction and network and operating health. The survey also points out that the current lack of information about intangible assets may compromise the ability of company directors to fully understand the objectives and risks of their companies.

Accenture's (2003) global survey likewise finds that company directors and others lack information about intangibles. Only 5% of companies have in place "a robust system that measures and tracks the performance of intangibles". This contrasts to 49% of company directors, who say that intangible assets are what their companies primarily relies on for shareholder wealth creation.

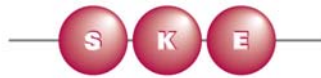
Similarly, 92 percent of participants in a Deloitte (2004) survey warn that traditional financial indicators found in financial statements are not enough to capture their companies' strengths and weaknesses and call for increased disclosure of EBR information. Although financial measures received a high rating from survey respondents in helping the Board and CEO make short-term decisions and in formulating strategy, such data was considerably less helpful in making mid- and long-term decisions and in achieving an appropriate valuation in capital markets<sup>ii</sup>.

**Figure 1 – Changing Information Requirements of Company Directors**



Source: McKinsey, 2005

Traditionally, a company's financial statements have been the cornerstone of investment decision making and performance evaluation. However, the findings of the McKinsey, Accenture and Deloitte



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pose a question as to whether financial statements provide sufficient information for business decision making in a change economy. This is consistent with academic research, which has questioned the value relevance of financial statements in a changed economy (see Lev, 2001; Mouritsen et al, 2004; Lev and Daum, 2004). Ballou et al (2004) explain that a lack of accounting for intangibles has resulted in a gap between market and book value. In 1980, the book value of the S&P 500 was 80% of market capitalisation, whilst in 2003 it was less than 33% (see also Lev, 2001, who finds that for every dollar on the balance sheet, \$6 is not). Consider also that, today;

- Google's market capitalization is app. US\$125 billion while its net tangible assets are worth US\$9 billion.
- Amazon.com has a market capitalization of US\$13.6 billion and a net tangible asset value of US\$76 million.
- Microsoft has a market capitalization of US\$271 billion and its net tangible assets are worth US\$36 billion

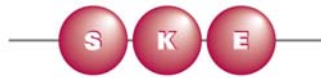
In Australia, similar trends are emerging. Research by AMP's Sustainable Alpha Team (2005) finds that 73% of the value of the typical Australian company is made up of intangible assets. Buffini (2005) argues that the International Financial Reporting Standard (IFRS) has done little to improve the situation, with the top 100 Australian organisations writing off \$7.5bn in intangible assets in 2005. There is broad based agreement, among practitioners and also researchers, that financial measures are incomplete<sup>iii</sup>.

Capital market players are also starting to look for more information about company performance and broadening their information searches to go beyond the P/L and Balance sheets. AMP, one of Australia's largest fund and wealth management companies, calls for a "New Era in Company Evaluation" (see Figure 2). They analyse more dimensions of company performance, including how companies manage their human capital, customer and community relations, supply chain, brand values etc. This may have a 'pull-effect' and as more questions get asked by capital markets to businesses for EBR information this may result in more companies measuring and reporting on their intangible assets.

**Figure 2 – Changing Information Requirements of Capital Markets**



Source: AMP Presentation, Sydney, Australia, February 2007



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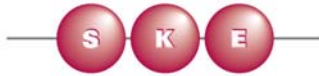
In terms of capital market effects, research has found that benefits accrue to those businesses who report EBR information. EBR reduces information asymmetry and improves a company's risk profile (through a reduction in beta), which in turn improves overall company valuation.

Guo et al (2005), for example, find that information about product development, R&D and the competitive environment reduces information asymmetry and assist IPO pricing.

Thomas (2003) examines the impacts of intellectual capital reporting with financial analysts in the UK using an experimental design. She finds that an increase in disclosure of intellectual capital information leads to a tighter range of share price estimates and a reduction in beta, resulting in a lower cost of capital.

Yet, whilst these early studies provide positive insights into the financial effects of EBR, academic research is still inconclusive and more empirical studies are needed to better establish the capital market effects of EBR.

Better articulation of the financial effects of EBR will also help provide greater incentives for business to engage in EBR and thus increase practice in the business community.

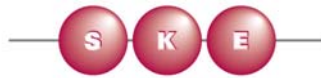


## 2. International Trends and Development in Enhanced Business Reporting

A growing number of reporting frameworks and measurement models have sought to address the changing information requirements of business executives and help narrow the 'value gaps' in financial markets. Internationally, the last decade has seen a proliferation of new reporting frameworks and models.

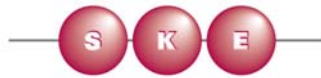
Table 1 summarises sixteen prominent initiatives that all focus on EBR. These are categorised at a Global, National and Company level<sup>iv</sup>. Notably, fifteen of the sixteen initiatives reviewed in Table 1 are Voluntary (V), whilst only one is Mandatory (M); a trend, which illustrates that, hitherto, the approach to EBR has largely taken place outside the realm of regulators. Initiatives that relate specifically to intangible assets and intellectual capital reporting include, among others:

- The Danish guideline *Intellectual Capital Statements – The New Guideline*. This was commissioned and published by the Danish Ministry of Science, Technology and Innovation in 2003. The Guideline is the outcome of a multi-year project with over 100 Danish organisations volunteering to participate in the production of intellectual capital statements and report on the performance and composition of their intangible, knowledge resources.
- The German Guideline *Intellectual Capital Statement – Made in Germany*. This was issued by the German Federal Ministry of Economics and Labour (FMEL) in 2004. The Guideline acknowledges the growing importance of knowledge and innovation to economic growth and seeks to help organisations portray and evaluate intangible corporate values in a structured manner (FMEL, 2004, p. 7). It acknowledges that traditional management control tools cannot provide sufficient information about business performance.
- The Australian *University Organisation and Studies Act*. This came into effect for all state universities in Australia on 1 January 2004. It mandates intellectual capital reporting for all universities as a basis for performance evaluation and aims to restructure the educational and legal framework of universities to ensure public budgets are put on a new, more performance-oriented basis. The intellectual capital reports are used for: 1) External reporting purposes to publicly account for the use of tax money, publish the university's performance, and to inform budgetary reimbursement and performance-oriented budget allocation from the Federal Ministry and private institutions; and 2) Internal management and control purposes to assist in performance evaluation enabling more efficient use of resources and improved management decision making and forecasting.
- The Japanese *Guideline for Disclosure of Intellectual Assets Based Management*. This was released by the Ministry of Economy, Trade and Industry (METI) in October 2005. The Guideline aims to assist corporations prepare intellectual assets reports. The guideline advocates sustainability and stakeholder engagement and aims to help managers develop a deeper understanding of the role intellectual assets plays in organisational value creation.
- The Australian *Guiding Principles on Extended Performance Management – A Guide to Better Managing, Measuring and Reporting Knowledge Intensive Organisational Resources*. This was issued in draft format by the Society for Knowledge Economics (SKE) in November 2005. The Guiding Principles encourages organisations to adopt a more strategic and inclusive approach to managing, measuring and reporting intangible resources. The Guiding Principles have since 2006 informed the Australasian Reporting Award on Knowledge Capital, to which a growing number of Australian organisations have been submitting reports.



**Table 1 – International Initiatives in Enhanced Business Reporting**

	<b>Initiative</b>	<b>Requirement</b>	<b>Category</b>
<b>Global Level</b>	<b>IASB Management Commentary</b>	In Discussion	Broad Based Enhanced Business Reporting
	<b>OECD Multinational Enterprise</b>	V	Corporate Citizenship & Sustainability
	<b>United Nations Global Compact</b>	V	Corporate Citizenship & Sustainability
	<b>United Nations Global Reporting Initiative</b>	V	Corporate Citizenship & Sustainability
<b>National Level</b>	<b>Australian Parliamentary Inquiry into Corporate Responsibility and Triple Bottom Line Reporting</b>	V	Triple Bottom Line and Corporate Citizenship & Sustainability
	<b>Australian Guiding Principles on Extended Performance Management (SKE)</b>	In draft format	Broad Based Enhanced Business Reporting
	<b>Austrian Universities Organisations and Studies Act</b>	M	Intellectual Capital
	<b>Danish Guideline on Intellectual Capital Reporting (MSIT)</b>	V	Intellectual Capital
	<b>German Guideline on Intellectual Capital Statements (FMEL)</b>	V	Intellectual Capital
	<b>Japanese Intellectual Based Management (METI)</b>	V	Intellectual Capital
	<b>MERITUM Guideline (EU Commission)</b>	V	Intellectual Capital
	<b>UK Operating and Financial Review (ASB)</b>	V	Broad Based Enhanced Business Reporting
	<b>US Enhanced Business Reporting Consortium</b>	V	Broad Based Enhanced Business Reporting
<b>Company Level</b>	<b>Balanced Scorecard (Kaplan and Norton)</b>	V	Intellectual Capital
	<b>Intangible Asset Monitor (Sveiby)</b>	V	Intellectual Capital
	<b>ValueReporting™ (PwC)</b>	V	Broad Based Enhanced Business Reporting



### 3. Observations and Commentary

A number of observations can be made about the initiatives reviewed in Table 1 and EBR practices in general.

One observation is that there has been a lot of growth and many attempts at better measuring and reporting intangibles in recent years. This is a positive development and a testimony that more and more nations are trying to counter the shortfalls of traditional financial reporting. The European nations seem to have been the most advanced and forward-thinking in measuring and reporting their intangible resources, with other countries lagging behind in terms of the proliferation and uptake of reporting practices.

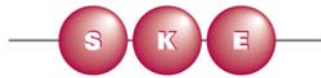
A second observation is that existing initiatives are very diverse. Whilst diversity and 'experimentation' in reporting frameworks and categories (as seen in Europe) can increase practical uptake, it may however also led to fragmentation and adversely affect information use. This is, for example, the case in capital markets where analysts and fund managers are looking for comparable data. To these users, diversity in reporting format and categories negatively impact their capacity to absorb and use EBR information.

Austrian research (Schaffhauser-Linzatti, 2004) on intellectual capital reporting, for example, finds that diversity reduces the general understandability and interpretability of intellectual capital reports. Specifically, this research argues that information usage is made difficult by:

- Missing uniformity of terminology and definitions
- Missing uniformity in approaches / frameworks for measurement and reporting
- Missing uniformity of use: internal versus external application and relevance.

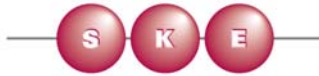
The Institute of Chartered Accountants in England and Wales' (Amber et al, 2001)<sup>v</sup> large study of the UK capital market likewise calls for heightened levels of disclosure of EBR information. The study finds that inconsistent reporting across years and companies limits the use of EBR information among analysts. They link this to transparency and competitive intelligence issues, and conclude that inconsistency makes it difficult for information users to absorb, compare and analyse EBR information. The study calls for greater reporting of comparable and consistent data across organisations and time periods.

A third observation is that reporting on intangibles and EBR information remains largely voluntary. The UK Operating and Financial Review was originally introduced as a mandatory practice for all UK public listed companies, but was, after a short time, made voluntary. The large scale Danish project on intellectual capital reporting likewise had limited impact on reporting requirements in Denmark, or more broadly in the European Union, resulting only in a one line addition in local regulation. The International Accounting Standards Board is likewise opting for a voluntary approach to include Management Commentary in financial reports in 2007, following agreement by 61% of respondents to their 2005 Discussion paper. Hitherto, the approach to EBR has largely taken place outside the realm of regulators. Broader uptake of EBR by business may require greater involvement of national and international policy makers and regulators.



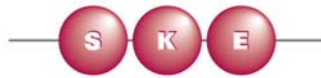
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### Footnotes

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<sup>i</sup> For more information about the Pozen Committee, see <http://www.sec.gov/about/offices/oca/acifr.shtml>

<sup>ii</sup> See also the 2003 Deloitte survey of 388 fund managers and 80 investor relations officers, which found that EBR information is also increasingly important to investment decision making, with an anticipated surge in demand for such information over the next 3 years.

<sup>iii</sup> A vast array of studies makes this observation (see for example the Australian Department of Industry, Science and Resources (2001), *Invisible Value: The Case for Measuring and Reporting Intellectual Capital*, Canberra, see also Mouritsen et al (2004); Lev (2001).

A lack of reporting of intangibles can:

- Result in understated earnings, as investments are expensed not amortised.
- Result in an understatement of the book value of equity
- Increase the cost of capital – WACC (beta)
- Lower share price due to increase in WACC
- Result in information inequality
- Result in underinvestment in the drivers of value creation and ineffective resource allocation

<sup>iv</sup> The last column in Table 1 classifies the initiatives into four different categories, as follows:

1. **Triple Bottom Line (Social, Environmental and Economic Impact)** reports consider the external impacts of organisational activity, including, for example, the contribution of the organisation to the national economy, the community and the environment.
2. **Corporate Citizenship and Sustainability** is concerned with stakeholder interests, human rights issues, labor relations and environmental impacts. Focus is largely on multinational enterprises and on minimizing the adverse effects of globalization and ensuring the sustainability of the 'global village'.
3. **Intellectual Capital** reports record information about the composition and performance of organisational intangible resources, such as relational, human and structural capital. They are primarily concerned with how such knowledge resources are managed, developed and utilised in the pursuit of a company's strategic objectives.
4. **Broad Based Enhanced Business Reporting**, embraces elements of both intellectual capital (including relational, structural and human capital), the triple bottom line (including social, environmental and economic impact reporting), and stakeholder interests and sustainability. It is used as an overarching term used to embrace the above mentioned categories.

For a detailed review of the sixteen initiatives, please see Boedker C., Guthrie J. Binney D. (2007), "Intangible Drivers of Organisational Productivity and Prosperity – International Trends and Developments in Extended Performance Management, Measurement and Reporting", Department of Finance, Canberra, published by the Society for Knowledge Economics, Australia, download a free copy from <http://www.ske.org.au/reports.php>

<sup>v</sup> This study was based on:

- Content analysis of annual reports of 125 FTSE companies
- Interviews with 47 Chairpersons / Senior Executives
- Survey sent to 1568 financial analysts, response from 290 (18.5%)
- Interviews with financial analysts