IPR, Intangibles & Valuation: Visualising Information for Finance Access

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“The substantial foundation of the industrial corporation is its immaterial assets”

“There may be peculiar difficulties in the way of reducing this goodwill to the form of a fund, expressing it in terms of a standard unit”

Thorstein Veblen, 1904
AGENDA

1) Intangibles, Intellectual Capital and the new economic environment
2) The traditional accounting approach to intangibles (“the problem”)
3) A new approach to the management and reporting of Intellectual Capital
4) International initiatives
5) The way forward and concluding remarks
1. INTANGIBLES, INTELLECTUAL CAPITAL AND THE NEW ECONOMIC ENVIRONMENT
The New Value Creation Process and Its Implications

- Change in company production processes
- Strategic aspects are research and innovation, marketing and know-how, customer relationship, entrepreneurial and managerial skills and not so much manufacturing ‡
- All phases and activities where intangibles are key ‡ Patents & IPR are crucial intangibles
- Today, intangibles are considered the main drivers of sustainable value creation over time
Towards the “Conceptual Company”
(Greenspan/Lev)

• Negligible physical assets (low PP&E, inventories)
• Intangibles-intensive: R&D, brands, alliances, human resources, organization capital
• Strong patent/trademark protection
• Extensive outsourcing of manufacturing, distribution and other low-knowledge functions
• Extensive trade in intellectual property (IP): patent sale and licensing, know-how sale
• Flexible business model
Intangibles and Risks

• However, investment in intangibles is associated with high levels of uncertainty in terms of outcomes and timing.

• Hence, intangibles have also a negative side. Recent history has shown that intangibles may “evaporate” very fastly, giving rise to large losses. Intangibles are also a potential liability.

• Fundamental lack of methodologies for measuring and assessing intangibles-related risks.
Definitions of Intangibles

Intangible assets can be defined as a source of future benefits that is without a physical embodiment:

- **Intellectual property** is an intangible asset with legal rights

- Includes innovation-related intangibles (R&D, patents), but also market-related (brands), human resource (competencies & skills, training), and organizational intangibles (internal structures, systems, procedures, routines, and processes)

- “Hard” intangibles (tradable) vs. “Soft” intangibles
Intellectual Capital

Intellectual Capital – IC – is the internal (competencies, skills, leadership, procedures, know-how, etc.) and external (image, brands, alliances, customer satisfaction, etc.) stock of intangibles “available” to an organisation, which allows the latter to transform a set of tangible, financial and human resources into a system capable of creating stakeholder value through the pursuit of sustainable competitive advantages (Zambon, 2000)

Intangibles become IC only when they are durably and effectively internalised or appropriated by an organisation
Intellectual Capital as Disaggregation of the Market Value

Re-focussing Managerial Attention on Intellectual Capital

• Need for regaining control by managers on the performance and knowledge generation processes ‡ understanding long-term value creation drivers

• According to Mr. Sam J. Palmisano, Chief Executive Officer (CEO) of IBM (April 2006):
  “The economy is re-aggregating itself around the Intellectual Capital, the capacity of making technology and information live together as innovation”
2. THE TRADITIONAL ACCOUNTING APPROACH TO INTANGIBLES (“THE PROBLEM”)
THE BASIC PROBLEM

Companies need to manage their intangibles in order to manage in a conscious way value creation processes.

Information is necessary to manage.

There is a lack of structured, systematic, reliable, and comparable information on company intangibles.
Traditional Accounting for Intangibles  
(e.g. International Accounting Standard no. 38)  
• General suspicion of accountants towards intangibles  
• Stress on reliability and not on relevance $\neq$  
  no reliability = no accounting recognition  
• No recognition possible for internally generated  
  intangibles (e.g. R&D, Brands, Training)  
• Conservative measurement criteria $\neq$ general  
  principle: immediately expensed as a cost  
• Goodwill is a too synthetic representation of intangibles  
• In general, rather poor information on long term  
  growth drivers (key performance indicators – KPIs)  
• Backward-looking information
This situation of lack of information on intangibles induces many adverse economic consequences:

- It easily produces short-termism, behavioral myopia, ill-informed allocation decisions, market volatility, information asymmetry, insider information, credit crunch for companies, etc.

- Risk is seen only in monetary/financial terms
“Information Cascade” Effect

• In this situation of information and valuation deficit on Intangibles, there is a serious risk that an information cascade phenomenon could take place (Zambon, 2003)

• In behavioural finance, this effect occurs when one agent looks at the behaviour of other agents for making a decision ‡ spreading of partial ignorances

• “The blind that leads the blind” effect ‡ increase in price volatility in the financial markets and in company cost of capital
Costs of Mismeasurement

- Firm level: risk of wrong strategies
- Industry level: misallocation of resources within and between industries; skill bias
- Capital market level: under- or over-valuation of companies; misallocation of resources; volatility
- Country and Supra-National level: policy making based on imperfect set of indicators may result in inappropriate policies
3. A NEW APPROACH TO THE MANAGEMENT AND REPORTING OF INTELLECTUAL CAPITAL
The Future: A New Management and Reporting Tool

Intellectual Capital (IC) Statements or Report on Intangibles are based on indicators most of them of a non-financial nature.

The partitioning of IC into three interrelated sections is today quite widely accepted: Human Capital, Organizational Capital (including Innovation Capital), Relational Capital are visualised/measured through indicators and parameters, and accompanied by a Narrative that links these parameters with company Strategy.
IC Report Composition

- Clients
- Suppliers
- Business Partners
- Image/Reputation on the market
- Communication

- Know-How / IPR
- Innovation
- Organisation
- Management Control Systems
- R&D

- Skills & Competencies
- Staff Turnover
- Education level
- Management Leadership
- Employee Satisfaction / Engagement
Benefits and Features of IC Visualisation

Internally

• Creation of a measurement and codification culture
• Knowledge management and sharing within org’ on
• Identification of intangibles-linked value drivers & risks
• Support to the investment/divestment decisions
• Definition of new executive compensation and incentive systems
• Improvement of the internal corporate image
• Aid to the recruiting of the best talents
• Help to get R&D/IPR Depart out of a sort of “ghetto”
Benefits and Features of IC Visualisation (2)

Externally

- Better visualisation of company value creation processes for investors & financial analysts
- Easier – and possibly cheaper – access to funding sources from banks (Basel 2 ratings)
- Increased transparency on financial markets
- Support to merger and acquisition operations and stock exchange listings (initial public offering – IPO)
- Positive impact on external co. image & reputation
- More solid and documented disclosure on sustainable competitive advantages
The Future: Intellectual Capital and Corporate Social Responsibility (CSR)

Social and Environmental Issues can be seen as part of the management of Intellectual Capital (image/reputation/risk management)

Therefore, social and environmental capital can be considered as particular intangibles to be managed by companies for achieving long-term sustainability and preserving income generation capacity toward convergence towards “One Report”
The Integrated Reporting System
(Zambon, 2003)

TRADITIONAL FINANCIAL REPORTING

SOCIAL/ SUSTAINABILITY REPORTING

INTANGIBLES/ INTELLECTUAL CAPITAL REPORTING

Set of common indicators on intangibles and risks

ENVIRONMENTAL REPORTING
a simple business idea

Produce the most performing brakes in the world
Relational Capital

Performance
• Revenues acquisition Index (existing customers)
• Revenues acquisition Index (new customers)
• % revenues from products developed in the last 5 years
• Market share
• Customer satisfaction Index

Sustainability
• Corporate image (external)
• Revenues concentration index
• Most relevant Customer penetration index
• % revenues invested in Marketing & Ext. Communication
**Performance**

- % position coverage with internal growth
- Index of multi-competence
- Average level of leadership management
- Level of trust
- Management average age
- People Education/School Index

**Sustainability**

- % revenues invested in training
- People satisfaction index
- Multi-valence index
- % female representation within management
- Turnover (management)
- Turnover (employees)
- Turnover (blue collars)
- Average seniority (management)
- Average seniority (employees)
Performance
• N° patents (licensed/active)
• Projects (Gate 7ok) / Technical Workforce
• Global Productivity
• Global TRS
• Grievances severity index
• PPM customers at km 0
• Internal scrap
• % non-conformance costs/revenues

Sustainability
• % revenues invested in R&D
• Change proposals/active projects
• Customer satisfaction (technical area)
• % conformity (internal audits)
• Corporate Image (internal)
• Value Alignment
• % revenues invested in internal communication
THE MODEL FOR RANKING IC & INTANGIBLES
DISCLOSURE by Italian Association of Financial Analysts &
Univ. of Ferrara, 2002

LEVEL 3
Full IC Report

LEVEL 2
Synthetic information
with an ad hoc table
in the annual report

LEVEL 1
Minimal information

Level 1
Minimal information:
- enclosed in the annual report (MD&A)
- mainly orientated to actual figures

Level 2
Extended information:
- enclosed in the annual report (MD&A)
- orientated also towards prospective information
- IC information is generally disclosed in ad hoc Table

Level 3
Extended and autonomous information:
- Ad hoc report on IC and intangibles

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ACTUAL INFO

PROSPECTIVE INFO

Customers/Suppliers

Organisation

Innovation & IPR

Strategy & Business Model

Human resources
Development of the Radar Diagram for evaluating the level of disclosure on Intangibles (B & Z, 2003)

0-5 = Insufficient; 5-10 = Sufficient; 10-15 = Excellent
Sample and data collection: an example

- **Sample**: French, German, Italian and UK companies composing the main indices of each national Stock Market (CAC40, DAX30, MIB30 +Midex, FTSE100)

- **Exclusions**: Companies from financial and insurance sectors as well as non-national companies have been excluded

- **Total sample**: 27 companies in France, 19 in Germany, 28 in Italy, 65 in UK

- **Document considered**: 2001 annual report
Results - Germany

CUSTOMERS & MARKET

HUMAN RESOURCES

CORPORATE GOVERNANCE

INNOVATION & IPR

ORGANISATION

STRATEGY
Results - Italy
Results – United Kingdom
# Results – Areas of Hexagons

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<tr>
<th>COUNTRY</th>
<th>AREA (Units)</th>
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<tr>
<td>France</td>
<td>77.04</td>
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<tr>
<td>Germany</td>
<td>72.57</td>
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<tr>
<td>Italy</td>
<td>53.93</td>
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<td>UK</td>
<td>39.17</td>
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Disclosure on Intangibles:
The simulated European best practices

Area of simulated hexagon = 119.48 units
Some critical issues of these new measures

Despite their value and innovativeness, these measures face some critical issues concerning their:

- consistency / comparability: some form of international standard is needed
- reliability (auditability)
- thoroughness / completeness
- meaningfulness:
  a) subjectivity in the choice of the “useful” indicators
  b) indicators do not possess additive properties
  c) high company specificity of indicators
4. INTERNATIONAL INITIATIVES
A series of European initiatives at an institutional level


Partners:
- University of Ferrara (lead partner)
- New York University (Prof. Baruch Lev)
- Melbourne University (Prof. Margaret Abernethy)

A series of European initiatives at an institutional level (cont’d)

2005-06: European Commission’s (DG Research) study on IC reporting to increase R&D in SMEs and help these companies to access bank credit (RICARDIS) published in June 2006

Some recent international developments in IC Reporting

The Intellectual Assets-based Management (IAbM) initiative by the Japanese Government and business community is expanding.

Interest by World Bank continues (Regional/Cities/Communities IC) ‡ Paris Conferences

Research in this area by the Organisation for Economic Cooperation and Development (OECD) is also progressing.

Also the World Intellectual Property Organisation (WIPO) is addressing the “IC Readiness” issue.
Some recent international developments in IC Reporting
(cont’d)


2nd International OECD Policy Conference in collaboration with the METI of the Japanese Government (Tokyo, 7-8 December 2006)
Some recent international developments in IC Reporting (cont’d)

Increase in the interest of statistical agencies at national and international level e.g. U.S. Federal Reserve, UK Statistical Office, Eurostat “Growth Accounting” approach

The United Nations International Conference in New York, 23-24 June 2008 on “Information Gaps at Micro- and Macro-Level” session on IC information and reporting
Other relevant initiatives

• “Wissenbilanz phenomenon” in Germany
• Austrian law mandated IC Reports for universities
• The “PIP Project” in Nordic countries
• The “Observatoire sur l’immateriel” in France
• The “Value Reporting” by PwC
• The IC Rating
• Intellectual Assets Centre in Glasgow
• The VALI Project” in Italy for IC Reporting of small-medium enterprises (SMEs)
Principal Guidelines on IC Reporting

- International Federation of Accountants (IFAC) – Study no. 7 (1998)
- Nordika Project Guidelines (2001)
- German Ministry of Labour (2004)
- Putting IC into Practice Guidelines (PIP) by Nordic countries (2006)
Ten principles for effective communication of IC

Why and how the financial community should tackle intangibles – now
The Future: the IASB’s Management Commentary

• In June 2009 IASB has published an Exposure Draft on Management Commentary (MC) due to be a voluntary Guidance and not a Standard

• It sets out principles, qualitative characteristics, and content elements of Management Commentary to provide capital providers with decision-making useful information for understanding management’s objectives and related strategies

• Management Commentary should especially provide forward-looking (future-oriented) non-financial information especially on intangibles
The Future: the IASB’s Management Commentary (2)

• Attention should be given to the commentaries on the nature of the business, management objectives and strategies, main resources-risks-relationships, results of operations and prospects, & critical performance measures and indicators

• Management Commentary includes financial and non-financial information ‡ inclusion of key-performance indicators (KPIs) ‡ how non-financial factors have influenced and will be able to influence financial performance
The “World Intellectual Capital/Assets Initiative” (WICI)

*The world's business reporting network - www.worldici.com*

Since 2007, the aim is to work towards a new and global framework for business reporting worldwide based on industry-centred KPIs

**Members**
- Japanese METI (Ministry of Economy, Trade & Industry)
- U.S. Enhanced Business Reporting Consortium (EBRC) [AICPA, PricewaterhouseCoopers, Grant Thornton, Microsoft]
- European Financial Analysts (EFFAS)
- OECD
- Brazilian Development Bank (BNDES) (observer)
- Society for Knowledge Economics in Australia (SKE)
- European Commission (observer)
- Waseda University
- University of Ferrara
Next WICI Deliverables

- Commentaries on relevant international documents (e.g. IASB’s Exposure Draft on Management Commentary)

- Development of a more comprehensive business reporting framework (combining generalisability & specificity)

- Development of KPIs per sector/industry:
  - Electronics (WICI Japan)
  - Pharmaceutical (WICI Japan)
  - Automotive (WICI Japan)
  - Telecommunications equipment & services (EFFAS CIC)
  - Software and IT services (EBRC + Gartner)

- XBRL-ization of KPIs information
### WICI Framework versione 1.0
(already tagged with XBRL - www.worldici.com)

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<th>0 Corporate profile and business attributes</th>
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<td>0-2 Duration and results per business unit</td>
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<td>0-4 Competitive analysis</td>
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Comparability vs. Specificity: The “Inverted Pyramid” approach

- Non-financial indicators could be articulated in three levels: General, Industry, Company Specific. ✫ the “inverted pyramid concept”

Only the first two levels are to be agreed upon in the future
Reporting on Intangibles: combining comparability & specificity

- **General level**
  - Basic KPIs
    - (3-5 max.)

- **Sector level**
  - Industry-Specific KPIs
    - (10-20 max.)

- **Enterprise level**
  - Company-Specific KPIs
    - (no limit)
The Establishment of “WICI Europe”

On 29 May 2009 in Paris WICI Europe has been founded with the task of coordinating the European action and research in the area of non-financial and intangibles reporting

At the moment, there are a number of European countries where the formation process of a national WICI jurisdiction is ongoing:

- France
- Luxembourg
- the UK
- Italy
- Austria
Objectives of the WICI Europe
(from MoU of WICI Europe)

- To promote the management and reporting of intellectual capital/assets at company level throughout the world and primarily in Europe through cooperation among members

- To promote European and international dialogue on the management and reporting of intellectual capital/assets with other organisations & interested parties such as investors, companies and their representative bodies, policy makers, regulatory authorities, stock exchanges, standard setters & universities throughout the European region
5. THE WAY FORWARD & CONCLUDING REMARKS
Concluding Remarks

- The today’s economic environment and the Conceptual Company pose new challenges to managers, investors, policy makers

- It is important to learn how to visualise the link between value creation, management and intangibles/IPR through a new information set and reporting system to become a market standard

- Intangibles are also associated with risk risk management overlaps with intangibles management

- Financial Analysis communication of appropriate information on intangibles is necessary to value and price company processes
Main Policy Indication

• Urgent to improve information on intangibles and IPR at micro level initially in a non-mandatory perspective, because good indicators at micro level will also allow to build better indicators at regional, meso and macro level
Company Reporting: policy indications (cont’d)

• Policy aim: identify in a collaborative way (public & private) at an international level a standardised set of intangibles non-financial indicators serving as minimum common information denominator ‡ WICI is open to collaborations & join forces

• Need to develop and promote an innovative, integrated, reliable, and verifiable company reporting system

• Convergence between various forms of reporting and avoidance of proliferation of guidelines and alike
Final consideration

We face a major PARADOX:
- The more the economic system is based on intangible assets, the stronger it is (because they are major drivers of growth & value creation).
- However, at the same time:
  The more the economic system is based on intangibles, the more vulnerable it becomes.

The challenge we all face is to learn how to manage, organise, and report on these “invisible” resources.