ACCOUNTING FOR THE ELEPHANT IN THE ROOM

DISCLOSURE OF INTANGIBLE ASSETS IN NEW ZEALAND PUBLIC COMPANIES

Annual reports of all entities should, in addition to all information required by law, include sufficient meaningful information to enable investors and stakeholders to be well informed on the affairs of the entity.
– New Zealand Securities Commission (2004, p. 21)

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There's an elephant in the room.
It is large and squatting, so it is hard to get around it.
Yet we squeeze by with, "How are you?" and "I'm fine," and a thousand other forms of trivial chatter. We talk about the weather. We talk about work.
We talk about everything else, except the elephant in the room.

- from *The Elephant In The Room,* by Terry Kettering[1]

[1] Retrieved on 20 October 2005 from http://www.bartow.k12.ga.us/psych/crisis/elephant.htm.

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In common with the acknowledgement Stewart (2002) made to his Apple PowerBook – his "terrific tool and durable friend" – mine (on wireless broadband internet) has been an astonishing window to the world and aid to productivity.

ABSTRACT

Company market values often exceed the values that are published in company annual reports. One popular explanation for this discrepancy is that traditional company accounting and reporting practices ignore the potentially very large value creating impact of intangible assets, which are also often referred to as intellectual capital or knowledge resources.

The theories for measuring intangible assets are reviewed, highlighting the many conceptual and definitional problems that have been encountered. These problems are traced to the resource-based static perspective of intangible assets, which sees them as balance sheet items analogous to tangible assets. A recent transition from this perspective is identified in the literature, towards recognising that the value of intangible assets arises more from their use than their possession. This is a dynamic or flow perspective of intangible assets, which views them as knowledge resources used strategically to create value. Adopting this perspective shifts the intangible asset issue away from being an accounting matter based on reporting historical transactions, to become a corporate governance and strategic management matter concerned with reporting future value creation performance and capability.

The empirical research develops and tests a novel instrument for measuring intangible asset reporting in New Zealand public companies, building on recently introduced Danish intellectual capital reporting guidelines centred on this emerging dynamic perspective. Of a sample of 50 listed public companies, 84% are found to be voluntarily reporting their use of intellectual capital to create value, 16% extensively. The reporting differences between these companies are then explored. Nearly two thirds of the variation may be explained by a combination of differences in profitability, the capital market's perceptions of their future added value, industry differences of tangible asset intensity, company size and company expansion strategies.

The empirical findings show a positive relationship between higher levels of disclosure and the future value placed on companies by the capital markets, which suggests capital markets

reward companies that adopt a more open disclosure policy with a lower cost of capital and easier access to capital.

These outcomes are compared with the inconclusive results found in a control survey of intellectual capital disclosure based on the earlier static perspective using a commonly used disclosure measurement methodology. This comparison reinforces the relevance of the emerging dynamic perspective of intangible assets, and the value to be gained from adapting disclosure research methodologies that reflect this approach.

This research shows there is currently a very low level of performance outlook reporting by New Zealand companies, a finding consistent with international research. It may seem that the next logical step from disclosing how a company intends to use intangible assets to create value is for its management to report its view of forward-looking expected performance. However, the literature reports that companies with conflicting goals may undermine the confidence the capital markets are prepared to place on their projections. Capital markets prefer to make their own informed assessments of the future performance of companies based on their own external assessment of each company's business model.

In the context of the principles-based reporting guidelines in New Zealand's corporate governance regulatory framework, the findings of this research indicate that a small group of exemplar companies are leading the way towards a more comprehensive voluntary disclosure of their future value creation strategies. This offers evidence that the principles-based regulatory approach is working to raise the average quality of annual report disclosures by New Zealand public companies, though the uniformity and instant results of a rules-based approach are missing.

DEFINITIONS AND ABBREVIATIONS

AGCCKC	Australian Government Coordinating Committee on Knowledge Capital
AICPA	American Institute of Chartered Public Accountants
ASX	Australian Stock Exchange
CICA	Canadian Institute of Chartered Accountants
CLERP9	Australian Corporate Law Economic Reform Programme Stage 9
DATI	Danish Agency for Trade and Industry
DCF	Discounted Cash Flow
DMSTI	Danish Ministry for Science, Technology and Innovation
EU	European Union
EVA	Economic Value Added
FSB	Federal Standards Board
GAAP	Generally Accepted Accounting Practice
GRI	Global Reporting Indicators
IAS 38	International Accounting Standard 38
IASB	International Accounting Standards Board
IC	Intellectual Capital
ICAEW	Institute of Chartered Accountants of England and Wales
ICAS	Institute of Chartered Accountants of Scotland
IFRS	International Financial Reporting Standards
IPO	Initial Public Offering
MC	Management Commentary
MD&A	Management Discussion and Analysis (also sometimes MDA)
NZ	New Zealand
NZSC	New Zealand Securities Commission
NZSX	New Zealand Stock Exchange
NZSX50	New Zealand Stock Exchange Top 50 companies index
OECD	Organisation of Economic Cooperation and Development
OFR	Operating and Financial Review
PDF	Portable Document Format
S&P500	Standards and Poor Top 500 companies index (US)
UK	United Kingdom
US	United States of America
VAIC	Value Added Intellectual Capital
XBRL	Extensible Business Reporting Language
Y2K	Year 2000 (usage here refers to computer software date adjustment issues)

Note: Company stock exchange code abbreviations used in the text are shown in Table 4.2.

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