Adviesraad voor het
Wetenschaps- en Technologiebeleid

Advisory report 33
INCALCULABLE WEALTH OF KNOWLEDGE
Financial reporting and innovative capacity of enterprises

1. Introduction
This report was published at the request of the Minister for Economic Affairs. The request for advice reads: "We have requested the AWT to provide insight - preferably from an international perspective - into the rules and procedures that form the basis for financial valuation and reporting and the obstacles this throws up for incorporating intangible assets in that report, and whether - and if so how - the government can remove these obstacles. So the AWT report could lay the foundation for a revision of the said rules and procedures which would make the principles of financial reporting 'knowledge friendlier' and increase the innovation capacity of companies."

The Minister put the background to the request for advice as follows: "The importance of intangible investments (instruction, education, training, software, etc.) is increasing as the economy becomes more knowledge-intensive. A company's human capital increasingly determines the company's economic performance. It is striking, however, that these intangible investments are barely included in companies' current financial reports (at most under the item "goodwill"). In the present system, expenditure on instruction, education, training, software, etc. is deemed to be a cost and not an investment. So, the financial reports do not give a complete picture of the innovation potential of companies, but they do form the basis on which financial institutions decide whether or not to furnish risk capital to the company in question.

The problem is that young, knowledge-intensive, innovating enterprises that invest considerable amounts in R&D, instruction and training of staff and in software see the availability of external financial risk capital as a major bottleneck to increasing their innovation efforts. So, the current narrow principles for financial valuation and reporting are an obstacle to investment in intangible assets, at the expense of the innovation capacity and the expansion of mainly young, fast-growing enterprises".

The request for advice asks for factual information on the current state of affairs in relation to the above. The Council refers for this to the annex to this report. It confines itself in the main text to answering the question of whether a revision of the rules and procedures is necessary to make financial reporting 'knowledge friendlier'.

2. Some concepts
The request for advice mentions a number of important keywords: intangible assets, reporting of these assets in companies' annual accounts, the legal obstacles, and the international comparison. These concepts are briefly explained below. They are considered in more detail in the annex to this report.

Intangible fixed assets
Intangible fixed assets are demonstrable, separable, non-physical business assets such as R&D costs, costs of acquiring intellectual property rights (patents and licences), costs of goodwill acquired from third parties, etc. They are referred to as fixed assets if they will yield returns for the company in the future. Intangible investments can in certain circumstances be reported as an asset (put on the balance sheet and depreciated over several years) if they yield returns over a period longer than the financial year.

In addition to current assets (accounts receivable, stocks) and the financial fixed assets

(participating interests and/or investments), it is mainly the tangible fixed assets that are shown on a company's balance sheet: land, buildings, plant and machinery. The intangible fixed assets are generally considered to be a 'residual category', namely non-physical and not part of the financial fixed assets. The implicit question put by the Minister of Economic Affairs is whether in a knowledge society this residual category has not now become so large that it should rather be seen as a 'main category'.

Reporting
Investments can be reported in various ways, with internal reporting differing considerably from external reporting. In the first instance, the management of a company and, for example, banks when issuing loans, make use of financial data and other indicators which are not given in their external report; much of this information is sensitive, being of interest to the competition. In addition to the internal report, public and private limited companies in particular are required to publish an annual report, including annual accounts. The annual accounts comprise the balance sheet and the profit and loss account. The annual report further contains a description of the company's activities in the preceding year, of the strategy to be pursued and of its prospects. It may also contain additional information concerning environment and human resources policy, innovation policy and the like.

In the case of the balance sheet a distinction is made on the one hand between the balance sheet prepared for tax purposes, on which corporation tax is calculated, and on the other the commercial balance sheet, which is prepared for different purposes (in particular to provide information to shareholders and other stakeholders). The tax balance sheet is never published and is consequently of no relevance to the issue being discussed here. In most European countries the tax balance sheet is derived from the commercial balance sheet; in the Netherlands and the United Kingdom, as well as in the United States, the legal connection between the two balance sheets is not as strong, however, with the result that there are greater opportunities for carrying intangible investments as an asset and for depreciating them, although the conditions may be more stringent or less stringent per country.

The law in the Netherlands
Legislation governing the annual accounts and annual report can be found in Title 9 of Book 2 of the Netherlands Civil Code. The law came into effect in 1984 and replaced the 1971 Act on the Annual Accounts of Enterprises. When enacted, the law was also referred to as the Act approximating the 4th EC Directive, indicating that tax legislation was being aligned in connection with the pursuit of harmonisation within the EU. Any amendment of the law will therefore have to be considered from an EU perspective.

In the interpretation of the Dutch legislation the guidelines and considerations of the Council for Annual Reporting (RJ) play an important part. Internationally, this part is played by the International Accounting Standards Committee (IASC). The Council refers to the annex for the national and international guidelines and recommendations.

3. Linking financial reporting and innovative capacity

In the request for advice, an indirect link is made between making financial reporting knowledge-friendlier and innovative capacity. The request states namely that "financial reporting forms the basis on which financial institutions decide whether or not to furnish risk capital to the company in question". The Council has great doubts about this link, indirect or other.

Naturally, it is of great importance to many companies to have access to external capital in order to realise their growth potential. The Council thinks, however, that the way to do so should not be sought in making financial reporting 'knowledge friendlier' via rules and procedures with a view to incorporating intangible assets on the balance sheet. It is difficult, if not impossible, to implement this and it is not necessary, either.

The fact that it is difficult, if not impossible, to implement this already been argued and elucidated in various studies. In the annex to this report a number of studies are highlighted which show that it is very difficult, sometimes even impossible, to assess the value of intangible assets. There are very serious practical objections attached to determining the value of these assets. There are no adequate methods available. Consequently, it remains guesswork with, if formalised, all the attendant legal complications. It is therefore right, in the Council's view, that

Dutch legislation attaches very stringent conditions to the incorporation of intangible fixed assets on the balance sheet. There are also objections of principle, in particular as regards carrying human capital as an asset on the balance sheet. It is a simple fact that a company does not own its employees and they can leave - taking their knowledge with them. The Council refers here in particular to the 1996 OESO study which points to the practical objections and the objections of principle; the recent KPMG study also comes to the conclusion that reporting human resources as an asset on company balance sheets is not realistic. The Council concurs with the conclusions of these studies. And it is not necessary, either. When risk capital is made available, it is in the expectation of future growth. It is impossible to establish this growth potential via uniform rules and procedures. Every company must find its own way to the providers of capital. Financial analysts, venture capital companies, banks and institutional investors have proved to be quite capable of assessing the value of the knowledge and expertise within a company. The capital providers also have their own methods for estimating growth potential. The connection between those seeking and those providing risk capital can always be improved. Formal rules and procedures for financial reporting will be of no help in this.

This does not alter the fact that, for various reasons, companies themselves develop all kinds of alternative methods and techniques for quantifying their knowledge potential, for internal as well as external use. Examples of these are given in the annex to this report. It is up to the companies themselves to develop initiatives to this end if they so wish, but the Council sees no role reserved for the government in this respect.

4. Conclusion

The Council deems it appropriate that Dutch legislation governing annual accounts should impose very stringent requirements on the incorporation of intangible fixed assets on the balance sheet. It does not recommend a review of the rules and procedures to make external financial accounting and reporting 'knowledge-friendlier'. In the sphere of developing alternative methods for quantifying the knowledge potential of companies, the Council sees no role set aside for the government.

Written in The Hague on 6 March 1998

Dr. H.L. Beckers
chairman

Dr. A. van Heeringen
secretary