

Measuring and Reporting Intellectual Capital: Three Proposals from Canada

**Amsterdam
June 10, 1999**

Beverly Brennan, F.C.A.
Chair,
Canadian Institute of Chartered Accountants



Measuring and Reporting Intellectual Capital: Three Proposals from Canada

Outline

- **The challenge IC creates for accounting**
- **Possible responses to the IC challenge**
- **Restating the challenge to accounting**
- **What we're doing in Canada**
- **Proposals to the international accounting community**



1. The challenge IC creates for accounting

- **Financial accounting framework ignores IC**
- **IC relatively more important in a knowledge-based economy**
- **Failure to account for IC may lead to:**
 - **Misallocation of capital**
 - **Inadequate investment in IC**
 - **Misstatement of operating results**



2. Responses to the IC challenge

- **The “intangibles approach”:**
 - **Record IC, along with other intangibles, as an asset on the balance sheet**



CICA Publication on IC

Intellectual Capital Management: Challenge and Response, 1999



Intangibles approach has significant problems...

- Accounting model is based on *transactions* with 3rd parties
- IC measures are based on *indicators*
- There are serious conceptual and practical problems in attempting to combine indicators-based IC data and transaction-based accounting data
- Combining transaction-based and indicators-based data will likely satisfy no one



What are the alternatives?

- **“Performance Reporting” approach**
 - **Boards of Directors and Senior Management need “integrated” performance information about:**
 - » **Quality**
 - » **Employee training and development**
 - » **Customer satisfaction**
 - » **Productivity**
 - » **Environmental performance**
 - » **Etc.**



Performance Reporting Approach

- Objective is to define a framework that provides a comprehensive view of organizational performance
- IC will be a key part of the framework



3. Toward a deeper understanding of the IC challenge ...



Value creation and realization

- **Value *creation* and value *realization* are related, but different**
- **Financial accounting measures value realization, not value creation**
- **Challenge is to discover how to measure and report on value creation: i.e., value which is potentially available for realization**



The paradigm for performance reporting in the 21st century (1)

Value realized through transactions with third parties

Value creation indicators (TVC™)



The paradigm for performance reporting in the 21st century

Value realized through transactions with third parties

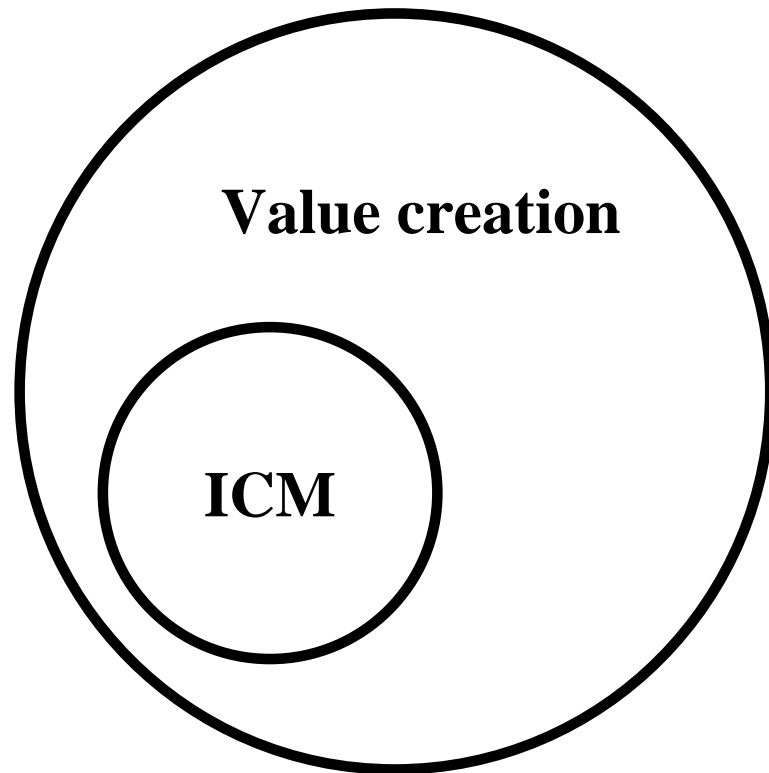
Traditional financial accounting and reporting

Value creation indicators (TVC™)

Parallel system of value creation accounting and reporting



ICM and value creation



- In a knowledge-based economy, ICM is a key element in creating value
- ICM is an important, but not the only, component of value creation
- As accountants, or people responsible for measuring and reporting on organizational performance, ICM has been the catalyst to force us to think deeply about how to fairly portray value creation.



4. What we're doing in Canada

...

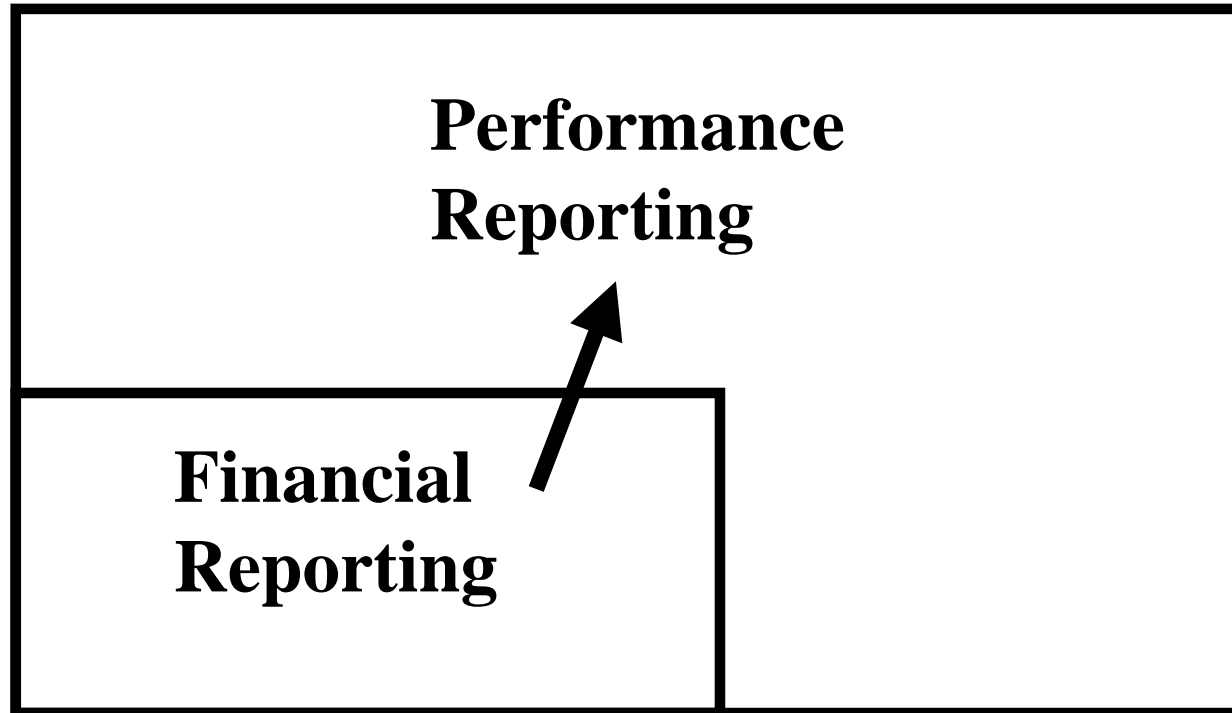


The Vision for CA's in Canada

“We will be the leaders in creating, validating and interpreting information that measures and enhances organizational performance, and be the obvious choice for financial management, assurance, and other specialized services.”



The Vision for CA's in Canada

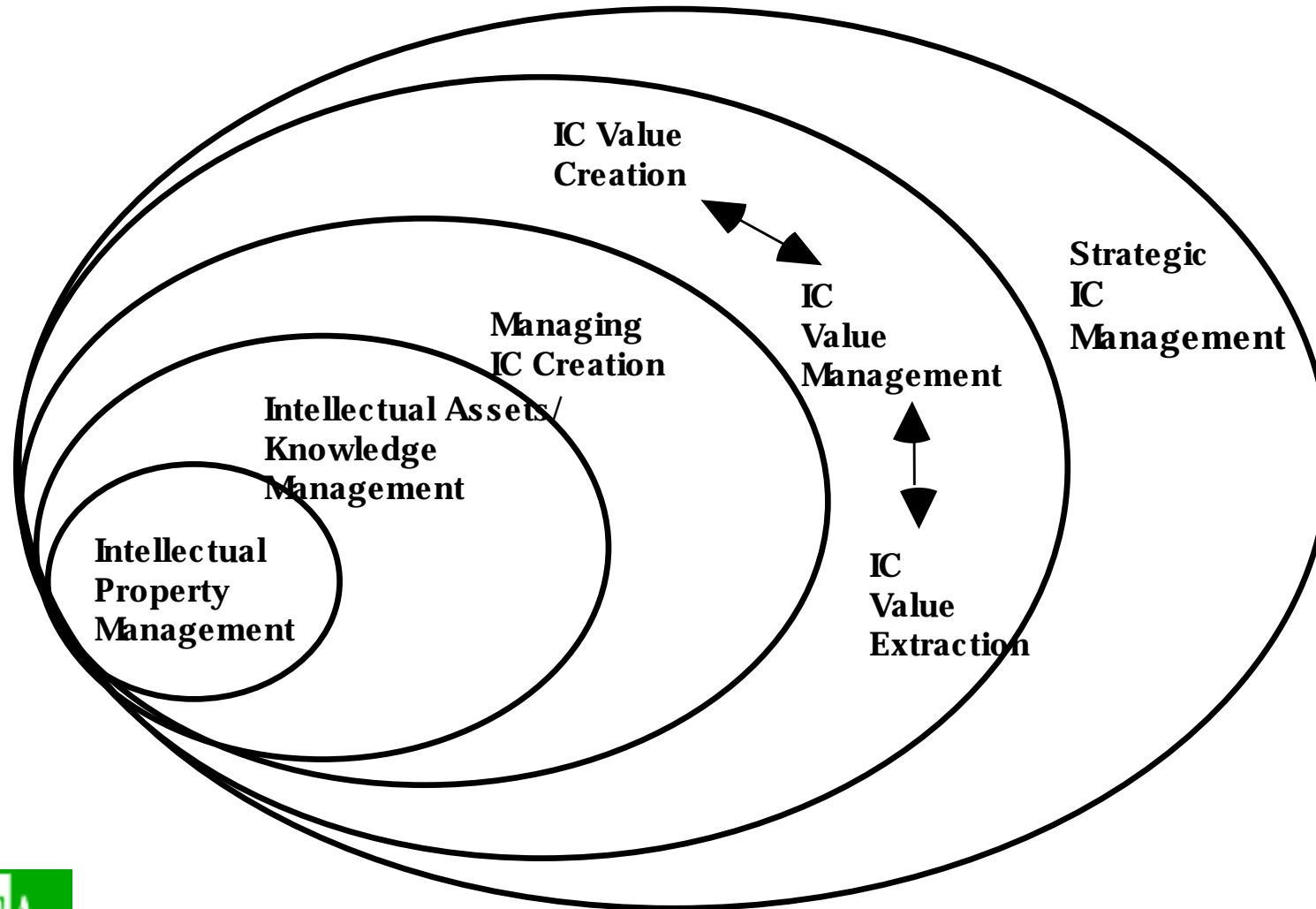


The Canadian Performance Reporting Initiative

- **Intellectual capital**
- **Integrated performance reporting**
- **Environmental performance reporting**
- **Shareholder value creation**



The ICM Evaluation Guide

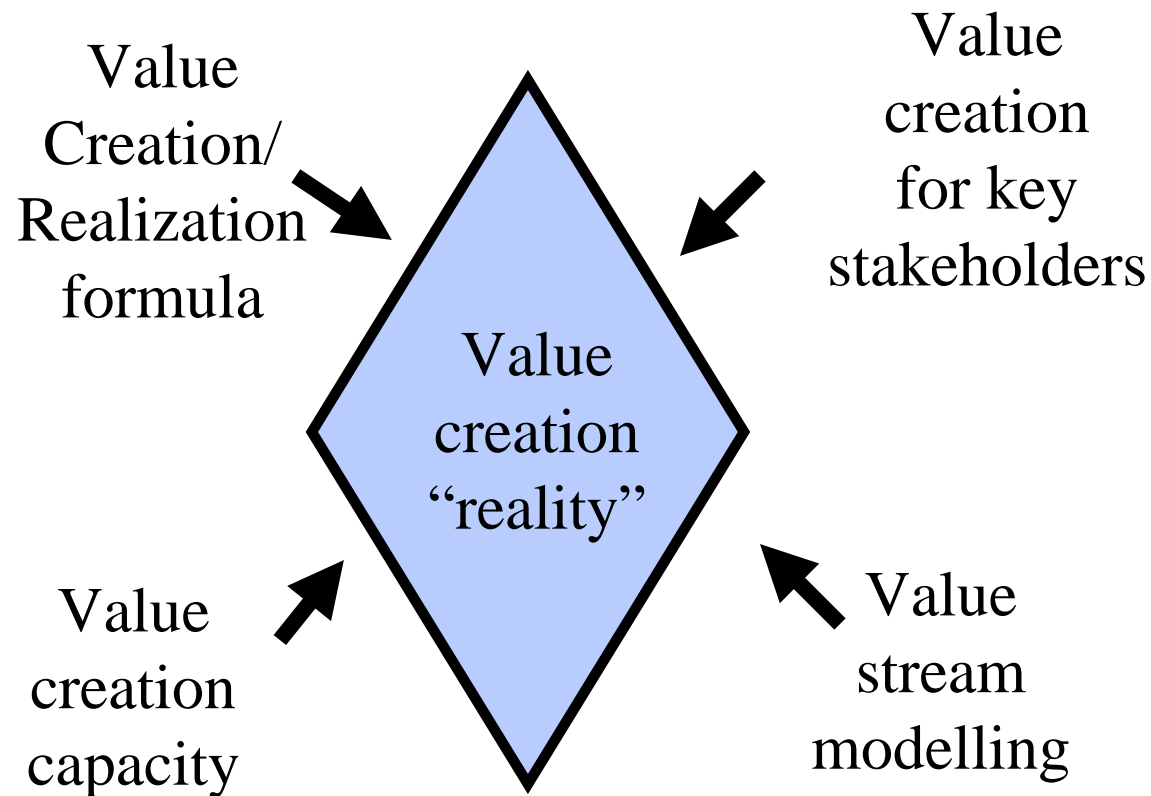


CPRI Board

- **Key priorities**
 - **Continue work on ICM Metrics**
 - **Major new initiative on Value Creation Accounting**



Perspectives on value creation: Potential elements of a TVC™ measurement framework



Canadian approach

- **Moratorium on standard-setting for at least 5 years**
- **Focus on encouraging experimentation with internal reporting to the Board of Directors and senior management**
- **Attempting to set standards too soon would discourage experimentation**



5. Proposals to the International Accounting Community



Proposals to the international accounting community

- 1. We should refrain from mandating external reporting requirements and standards for IC/ICM or value creation reporting for at least five years.**



Financial reporting versus IC reporting

Financial reporting

- 120 years of experience of modern accounting building on 500 years of experience with bookkeeping
- Numbers based on 3rd party transactions
- Universal language - we all agree on what accounts receivable are
- 100% of private sector firms with experience

IC reporting

- At most 10 years of experience
- Numbers based on indicators with varying reliability and relevance
- Not yet a common language (e.g., we don't all agree on what "structural capital" is or whether it's a useful concept)
- <1% of private sector firms with experience



Proposals to the international accounting community

2. We should encourage experimentation, and seek to remove any barriers to experimentation, in internal and external reporting on IC/ICM and value creation



Proposals to the international accounting community

- 3. We should develop mechanisms to enhance research collaboration, including exchanges on research priority and results, and work towards a common overall framework for IC/ICM and value creation research.**



In conclusion ...



*Don't play where the ball is.
Play where its going to be.*

