

To whom it may concern,

Re Corporate Disclosure of Intellectual Property

In response to the SEC's April 13 Concept Release No. 33-10064; 34-77599; File No. S7-06-16, and specifically to pages 67-70 related to disclosure requirements related to intellectual property, I attach as a public comment the following:

LAW JOURNAL ARTICLE

- Janice Denoncourt, True and Fair Intellectual Property Information: A Corporate Governance Issue (2016) Issue 1 Journal of Business Law , Sweet & Maxwell, pp47-72. See pre-print copy attached.

In summary of the paper, shareholders lack adequate quantitative and qualitative information about corporate intellectual property (IP) assets, impeding their ability to assess strategic value and directors' stewardship of those assets. The transparency problem and how directors fulfil existing obligations to provide "true and fair" IP information under UK law is examined in a corporate governance context. Similar issues arise in the United States and other jurisdictions.

PHD THESIS

- Janice Denoncourt, PhD Thesis (June 2015) "Patent-backed Debt Finance: Should Company Law Take the Lead to Provide a "True and Fair" View of SME Patent Assets" See <http://ethos.bl.uk/OrderDetails.do?uin=uk.bl.ethos.680271>

Abstract: Patent-backed lending to UK SMEs may be restricted if the value of internally generated patents is under-reported in financial statements due to International Accounting Standard 38 Intangibles. The accounting problem is exacerbated by company law requirements exempting SMEs from presenting a Strategic Report in the annual return. The astonishing lack of quantitative and qualitative public information about corporate IP assets makes it difficult to assess their strategic value ("the patent value story") and directors' stewardship of those assets resulting in a wider corporate governance issue. More relevant, accurate and timely corporate IP information (mostly known to internal management) is needed to triangulate intangibles financial data with narrative disclosure. An original business triage style narrative corporate disclosure model is presented.

FORTHCOMING RESEARCH:

I will be presenting a paper (currently in draft) to be delivered at the Society of Legal Scholars Conference at St Catherine's College, Oxford University in the company law section in early September 2016 with the provisional title, "Corporate Disclosure of Intellectual Property Assets: A Comparative System Evaluation of International Trends"

Abstract: In most jurisdictions, the corporate disclosure of intellectual property (IP) asset information is not as developed as the reporting of traditional financial information. There is both a lack of awareness of the financial and strategic importance of corporate IP assets and very little guidance from corporate regulators. The transparency problem and how company directors fulfil disclosure obligations to provide timely, relevant and useful information about their IP assets is examined in a corporate

governance context, adopting a comparative system approach exploring the United Kingdom, the United States and the Japanese experiences.

Please get in touch should you wish to receive any further information or assistance with respect to disclosure requirements related to intellectual property.

PROFESSIONAL AND ACADEMIC BACKGROUND:

Dr Janice Denoncourt is a Senior Lecturer at the Nottingham Law School, Nottingham Trent University in the United Kingdom. She is a British Council Chevening Scholar (2002), completed LLM degrees in Intellectual Property Law (2002) and Intellectual Property Law, Policy & Management (2003) and a PhD at the University of Nottingham (2015). She researches in the interdisciplinary field of IP and finance law.

In 2014, she was invited to speak on topic of IP Finance presenting 'Spin offs, Intangible Assets and Debt Finance' at the Global University Venturing Conference and 'IP Finance in the EU and Beyond...Does Law Matter?' at the IP and Venture Capital Symposium at the University of Tokyo.

On 28 September 2015 she presented, 'The Missing Link? Corporate Narrative Reporting of Intellectual Property Assets' at the International Association for the Advancement of Research and Teaching in Intellectual Property (ATRIP) 34th Congress in Cape Town, South Africa. In the same month she presented on 'Financing technological innovation: Analysis of WIPO's IP Advantage Database' to the Society of Legal Scholars 2015, University of York in the Intellectual Property section.

In addition, in late 2016, Janice will publish a monograph, IP Finance, Strategy and Corporate Governance as part of the Routledge Research in Intellectual Property Monographs Series.

Janice has also posted on the topic in the IP Finance Blog www.ipfinance.blogspot.com

Before turning to academe, Janice was a corporate lawyer having held positions as Senior Associate with Minter Ellison Perth, in-house counsel for a publicly listed Western Australian mining technology company and Legal Affairs Manager for a private UK company.

I would be grateful if you would kindly acknowledge receipt of my email contribution / response comment.

With best wishes,

Janice

Dr Janice Denoncourt
Senior Lecturer in Law
Nottingham Law School
Nottingham Trent University

True and Fair Intellectual Property Information: A Corporate Governance Issue

Janice Denoncourt*

Nottingham Law School

☞ keywords to be inserted by the indexer

Abstract

Shareholders lack adequate quantitative and qualitative information about corporate intellectual property (IP) assets, impeding their ability to assess strategic value and directors' stewardship of those assets. The transparency problem and how directors fulfil existing obligations to provide "true and fair" IP information under UK law is examined in a corporate governance context.

Introduction

This article examines the legal nature of "true and fair" intellectual property (IP) information disclosure in a corporate governance context in order to protect shareholders and help company directors meet existing obligations under UK company law. Shareholders and other stakeholders seek more relevant, accurate and timely information about corporate IP assets—the type of information known to internal management. At the same time, public disclosure of IP information and strategy invites both accountability and competitive exposure. Corporate disclosure of IP information and strategy is not as straightforward as reporting financial information. Consequently, even contemplating making multifaceted corporate intangible IP information more transparent causes many company directors to bury their heads in the sand. Even so, existing corporate governance principles aimed at increasing shareholder value demand transparency and better disclosure. IP rights are complex intangible legally recognised exclusive rights. The World Intellectual Property Organization describes IP as

"the creations of the mind, such as inventions; literary and artistic works; designs; and symbols, names and images used in commerce. IP is protected in law by, for example, patents, copyrights and trademarks, which enable people to earn recognition or financial benefit from what they invent or create. By striking the right balance between the interests of innovators and the wider public interest, the IP system aims to foster an environment in which creativity and innovation can flourish".¹

* Senior Lecturer in Law at the Nottingham Law School, Nottingham Trent University, UK.

¹ WIPO, *What is Intellectual Property?* (Publication No.450(E)), p.2, http://www.wipo.int/edocs/pubdocs/en/intproperty/450/wipo_pub_450.pdf [Accessed 14 October 2015].

IP is like any other property and allows the creators, or owners, of those rights to benefit from their own work or investment in a creation.² The scale of commercial value dependency on intangibles and IP assets has often been recognised. In March 2014 the Department of Business Innovation and Skills (BIS) confirmed that:

“Investment in ‘intangible’ assets has increased by more than 10% to £137.5 billion from 2009 to 2011 and nearly half of this investment was protected by formal Intellectual Property Rights ... Data shows investment in intellectual property and ‘intangible’ assets is growing and continues to outstrip investment in tangible assets, such as buildings and machinery, which fell slightly from £93 billion to £89.8 billion. The figures signal the growing value UK business attach to knowledge, innovation and creativity.”³

The shift to intangible IP assets as the major driver of value in corporations is clear. However, while IP rights are an asset class that continues to grow and underpin the financial health and wealth of UK companies, traditional financial reporting is ill equipped to deal with them and is compounded by underdeveloped corporate narrative reporting of valuable IP assets. This makes the invisibility of corporate IP information in company financial and narrative reports all the more astonishing and problematic from a shareholder protection point of view. Without timely, relevant and accurate qualitative and strategic IP information, the ability of shareholders to assess the financial and strategic value of corporate IP assets and monitor the directors’ stewardship of those assets is impeded. When it comes to treating intangible IP as a corporate asset class, it is important to understand the IP asset value story in connection with the company’s business strategy. This is the first step in assessing whether the company’s directors are managing those IP assets both in the interest of the company and to promote the success of the company as required by s.172(1) Companies Act 2006 (CA 2006). Thus valuing IP assets is not merely an accounting issue under the International Accounting Standard (IAS) 38 for intangibles⁴; the need to disclose “true and fair” IP information is an increasingly important issue for effective corporate governance.

In order to avoid singling out UK companies and the adequacy or otherwise of their IP information disclosures, the following example involves an American company. It is of interest because the transaction was widely reported and highlights the confusion surrounding IP value, demonstrating why enhanced narrative IP asset disclosure in the UK and other IP-rich jurisdictions is necessary. Motorola Inc was a multinational telecommunications company based in the US. On 4 January 2011, after having lost US\$4.3 billion between 2007 and 2009, the company was divided into two independent public companies, Motorola Mobility and Motorola Solutions.⁵ On 22 May 2012 Google Inc announced that it would acquire

² WIPO, *What is Intellectual Property?* (Publication No 450(E)), p.2, http://www.wipo.int/edocs/pubdocs/en/intproperty/450/wipo_pub_450.pdf [Accessed 14 October 2015]. IP rights are confirmed in art.27 of the Universal Declaration of Human Rights and their importance was first recognised in the Paris Convention for the Protection of Industrial Property 1883 and the Berne Convention for the Protection of Literary and Artistic Works 1886. Both treaties are administered by WIPO.

³ Department of Business Innovation and Skills Press Release (31 March 2014): “New figures published today show that UK business is building success through knowledge and creative assets.”

⁴ IAS 38 Intangibles, <http://www.iasplus.com/en/standards/ias/ias38> [Accessed 14 October 2015].

⁵ S. E. Ante, “Motorola is Split into Two”, *Wall Street Journal*, January 5, 2011.

Motorola Mobility's smartphone business and related IP assets for US\$12.4 billion.⁶ On 29 January 2014 Google announced that pending closure of the deal, it would sell Motorola Mobility to the Chinese technology company Lenovo for US\$2.91 billion (subject to certain adjustments). Google retained ownership of the vast majority of the Motorola Mobility patent portfolio, including current patent applications and invention disclosures. Lenovo agreed to license the patent portfolio and other IP assets, and further it acquired 2,000 patents outright as well as the Motorola Mobility brand and trade mark portfolio.⁷ The US\$2.91 billion is less than a quarter the amount Google Inc originally paid in 2012. The figure raised several important questions for shareholders. How did the directors arrive at US\$2.91 billion? What strategic business considerations were involved? Was the transaction in the best interest of the company? According to Generally Accepted Accounting Principles (GAAP), internally generated intangible IP assets are not reported as assets on the balance sheet of the company that created them. Consequently, valuing the IP assets and evaluating the acquisition price was hampered by the lack of publicly disclosed corporate narrative IP information to complement the off balance sheet figure. As a result, shareholders found assessing the impact of the licensing and sale of the former Motorola Mobility IP assets to Lenovo on their shareholding difficult.⁸ This illustrates why the IP information gap is problematic from a corporate governance point of view—shareholders' needs for corporate IP asset information are not being met. Annual reports are longer and richer in content (which make them more costly for companies to prepare), yet important IP information remains indiscernible. In 2012 the Association of Chartered Certified Accountants (ACCA), the global body for professional accountants, surveyed 500 annual report users in three common law jurisdictions: the UK, the US and Canada. It reported that shareholders (equity investors) are the foremost audience of the annual report and that their needs must be placed at the heart of future developments in corporate reporting. Fifty per cent of the survey respondents confirmed that the annual report is their primary source of information; however, more than a quarter of the sample (26 per cent) felt that it was difficult to assess a company's performance from the report.⁹ The Google-Motorola acquisition example echoes ACCA's finding as it demonstrates the tension between the value of corporate intangible IP assets and the inadequate way such assets are reported in financial statements.

The deficiency whereby traditional corporate financial reporting via the balance sheet is unable to adequately capture information about IP assets has been stressed in both the report *Banking on IP? (2013)*¹⁰ commissioned by the UK Intellectual Property Office and in the EU's *Final Report from the Expert Group on IP*

⁶ "We've acquired Motorola Mobility" (22 May 2012), Google Official Blog, <https://googleblog.blogspot.co.uk/2012/05/weve-acquired-motorola-mobility.html> [Accessed 14 October 2015].

⁷ Google Investor Relations Press Announcement, "Lenovo to Acquire Motorola Mobility from Google" (29 January 2014), <https://investor.google.com/releases/2014/0129.html> [Accessed 14 October 2015].

⁸ E. Kasznik, "Financial Reporting for Intangibles: the Case of the Invisible Assets" (14 August 2014), IP finance, <http://ipfinance.blogspot.co.uk/2014/08/financial-reporting-for-intangibles.html> [Accessed 14 October 2015].

⁹ Association of Chartered Certified Accountants (ACCA), "Accountancy Futures: Re-assessing the value of corporate reporting" (2012), p.4, <http://www.accaglobal.com/content/dam/accaglobal/PDF-technical/financial-reporting/reassessing-value.pdf> [Accessed 14 October 2015].

¹⁰ M. Brassell and K. King, *Banking on IP? The Role of Intellectual Property and Intangible Assets in Facilitating Business Finance*, Independent Report commissioned by the UK Intellectual Property Office (November 6, 2013).

Valuation (2014).¹¹ Both publications indicate that the UK and the EU seek to achieve a better understanding of interplay between IP rights and how their value as financial assets is communicated. The IP information gap is festering and needs attention from the corporate regulators. As a minimum, shareholders should have information about the directors' stewardship and management of the company's valuable intangibles and IP assets to allow them to make informed decisions regarding their investment. The information is also highly desirable for potential investors, financiers and creditors. With intangible IP assets dominating so much of our modern economy and the renewed drive to support and invest in new technology, the issue of the transparency and appropriate corporate disclosure of IP assets warrants detailed examination.

This article focuses on a practical commercial problem within a UK legal context. Corporate reporting is the main form of communication between companies and their shareholders. Enhanced narrative corporate IP information disclosure is a possible solution to overcome the accounting and financial reporting problem in order to improve understanding of how corporate IP assets operate within the company's business model. Companies and regulators need to ensure that existing corporate disclosure regimes capture and disclose relevant IP information as a matter of good corporate governance. The impact of the accounting treatment of IP assets under the requirements of International Accounting Standard (IAS) 38 Intangibles on corporate disclosure is examined. It is argued that company law should take the lead to ensure that companies provide a "true and fair" view of their corporate IP assets. The existing directors' duties and corporate disclosure requirements under the Companies Act 2006 are analysed and applied to corporate IP assets. The legal insights into this commercial problem provide an academic audience with a deeper level of legal analysis concerning the intersection between: (1) traditional financial accounting and reporting of intangibles and IP assets; (2) existing UK corporate disclosure requirements; and (3) the implications of enhanced IP asset reporting for corporate governance. The next section explains why relying on traditional financial accounting information in respect of internally created IP assets is insufficient from a corporate governance point of view.

The invisibility of IP information on the balance sheet—an accounting problem

Accountancy dominates IP valuation. As such, the accounting discipline is a macroeconomic instrument of formidable proportions in the realm of corporate assets. The objective of corporate financial statements is to provide information about the financial position, performance and changes in financial position of a company that is informative for a wide range of users in making economic decisions.¹² Users may include directors, managers, shareholders, prospective investors, financial institutions, suppliers, customers and employees, government, competitors and the general public. However, company information about intangible IP assets is largely invisible on traditional financial statements. In spite of that, it has never been more necessary for shareholders and other stakeholders to be able

¹¹ Commission, *Final Report from the Expert Group on Intellectual Property Valuation* (March 2014).

¹² International Accounting Standards Board (IASB) Framework.

to understand the objective value and the subjective quality of IP assets, as a form of currency, unit of account or as a store of value. Accounting statements provide information that shape a particular understanding of a business. However, the accounting principles that underpin IAS 38 Intangibles rely on two inherent assumptions: first, tangibles rather than intangibles contribute to business performance, and secondly, business depends largely on an arm's-length transaction between a willing buyer and a seller. Neither of these assumptions accommodates the nature of IP assets internally developed by a company.¹³

Intangible assets have been variously defined, but the common thread of the definitions is that these assets provide future benefits but do not have physical embodiment. The "future benefit" aspect helps to explain why their value is recorded "off balance sheet" and does not form part of the financial statements. Traditional financial statements are designed to record past transactions, not potential future financial benefits. In the UK, intangible assets such as patents, brands, customer relationships, information technology and knowhow are accounted for in one way if they are created in house (internally generated) and another if acquired (purchased). Using patents as an example, under IAS 38, if a patented invention is developed in house by an innovating company it is not recorded in the company's balance sheet nor is it evidenced in the company's financial statements. Rather it is immediately expensed, thus appearing as a loss, rather than as revenue. Further, these costs are reported only at a single point in time. Thus patent assets internally generated by a company are valued at little more than the patent attorney and patent filing fees, because the research is deducted as an expense, and not capitalised. In contrast, patent assets that are purchased are recorded at fair value using the purchase price and the assets are amortised accordingly. The price paid for the patents acquired in an arms'-length transaction provides objective market information as to the value of those intangible assets for accounting purposes, which is positively recognised under IAS 38.¹⁴ However, it no longer makes sense that the intangible IP assets a company develops itself are valued "at cost" because the research is deducted as an expense under IAS 38, while assets that are purchased at arm's length (such as the Google Inc patent acquisition discussed above) are recorded at "fair value". This accounting treatment results in inconsistency and makes it very difficult to compare the corporate finance and performance of IP *developers* versus IP *acquirers*.¹⁵ For example, the different accounting treatment means that a patent developed by company X and then sold to company Y can change from a very low valuation to a high valuation, possibly worth hundreds of thousand or even millions of pounds, overnight. This is the crux of the accounting problem for IP assets. Almost a decade ago in 2005 WIPO recognised that current accounting standards are ill equipped to address the IP dimension of business and issued the following statement:

"Clearly, the various challenges associated with determining the value of internally held intellectual property, paired with the inherent volatility associated with the value of some forms of IP, can be cited as major reasons

¹³ R. Ghafele, "Accounting for Intangibles" (2010) 5 *Journal of Intellectual Property Law and Practice* 521.

¹⁴ Ghafele, "Accounting for Intangibles" (2010) 5 *Journal of Intellectual Property Law and Practice* 521, 527.

¹⁵ Licensing Executive Society, Transcription notes of the F-16 Committee Meeting: Reporting Intellectual Property (Washington, D.C., May 2, 2002).

why accounting has been reluctant to report on internally generated IP, which is seen as too subjective and risky. Furthermore, accounting has always been reluctant to anticipate future gains, overstate the value of assets or include assets on the balance sheet whose value is more volatile.”¹⁶

If internally generated corporate IP assets are inadequately financially recorded for modern purposes, this results in a lack of financial transparency. From the shareholder’s point of view, this “invisibility” creates a key problem in that nothing exists on the financial statements (documents that they are familiar with) to quickly tell them how to value the firm’s internally developed IP assets. The undesirable level of uncertainty from the shareholder’s perspective is a formidable barrier which prevents appropriately informed decisions being made. In order to assess the directors’ and company’s performance appropriately, a shareholder needs relevant accurate information to accurately value the company’s IP assets within the context of the corporate objectives and business strategy. The IASC’s former Secretary-General, Sir Bryan Carsberg,¹⁷ stated:

“Knowledge about intangible assets, particularly how to value them, is still in its early days. IAS 38 reflects the current limits of this knowledge, focusing on reporting the cost of intangible assets. There is growing demand for further information on the value of intangible assets using financial and non-financial indicators, maybe not as part of the financial statements. Debates on the subject are very much alive. The IASC will watch the developments in this area and may do more work in the future when preparers and users have gained more experience on the value of intangible assets.”¹⁸

The weaknesses inherent in the financial reporting of IP asset value were also confirmed in the *IP Valuation Report* (2014), which states:

“There are limitations on when and how it is possible to place the value of IP assets on the balance sheet of the company. The complexity of IP from an accounting perspective leads to problems in its reporting, which may result in the vulnerability of firms which base most of their performance on IP.”¹⁹

IAS 38 recommends showing intellectual capital (which includes IP) in the notes to the balance sheet. However, such notes are very brief and are only designed to clarify and explain specific individual line items in the financial statements and would not normally be comprehensive. IAS has a high standing globally through policies designed to foster long-term agreement between domestic standards (as in the UK and other countries with well-developed accounting professions) and international standards; however, the flip-side is that IAS 38 is well entrenched internationally. As it currently stands, IAS 38 continues to reinforce a lack of consistency between internally generated and purchased intangible IP assets as it appears to give precedence to historical cost.²⁰ Further, it restricts the development

¹⁶ Ghafele, “Accounting for Intangibles” (2010) 5 *Journal of Intellectual Property Law and Practice* 521, 527.

¹⁷ From 1995 to 2001, Sir Bryan Carsberg was Professor of Accounting and Business Finance at the Victoria University of Manchester and served as the IASC as Secretary-General. Sir Bryan was formerly head of the UK’s Office of Fair Trading (OFT), which officially closed on 1 April 2014.

¹⁸ European Observatory on Intangible Assets, International Accounting, http://www.ii-a.fr/intangibles/international_accounting.htm [Accessed 14 October 2015].

¹⁹ Brassell and King, *Banking on IP?* (6 November 2013), p.6.

²⁰ Historical cost means the original cost at the time of a transaction.

of useful and relevant information for shareholders and other company stakeholders. Thus the accounting problem is exacerbated by the harmonisation of the international accounting standards, specifically IAS 38, which further influences IP valuations and reinforces how this information is communicated to shareholders. Despite the shortcomings, this is the price of harmonising accounting standards.²¹ Solving the accounting problem may require the introduction of a new bespoke accounting standard for internally developed intangible assets. According to Tom Chambers of PriceWaterhouseCoopers, this will involve

“the development of reliable and valid measurement methodologies for value-relevant, non-financial performance measures that have predictive value — measures that are an indication of how much shareholder value will be generated in the future. The Value-Reporting model is about broadening corporate reporting to have companies identify and meet analysts’ and investors’ needs for relevant information about value drivers, intangible assets and estimated future cash flows. Many companies have already started in this direction with new internal metrics”.²²

Currently, such a bespoke standard does not exist and will need to be created and adopted by the IASB. This is the precise point at where the deficiency in accounting needs to be addressed by corporate governance. The object of financial reporting, which the detailed accounting standards are designed and assumed to achieve, is to present a “true and fair” view of financial position of the entity at a particular point in time. As a matter of corporate governance, if internally developed intangible IP assets are material assets of the company, yet are not visible on the balance sheet, they still warrant disclosure. Narrative disclosure of qualitative IP information is needed to provide shareholders with a “true and fair” view of their value to the company’s growth prospects. Ultimately, *the law* evaluates what is “true and fair”. Next we will consider how the IAS intersect with company directors’ duties and whether quantitative IP information meets the “true and fair view” standard of disclosure.

The law and corporate financial statements

Presently Pts 15 and 16 of the CA 2006 drive the legal requirements for corporate accounts, financial reporting and audit. But, as always, human actors act before and behind the scenes. Therefore, it is of the highest importance to study how company law influences corporate reporting financial and narrative reporting of IP assets. A company’s financial statements are required to comply with ss.393–397 and s.495 CA 2006. The critical legal question is whether the traditional accounting treatment of intangible IP assets applying IAS 38 meets the overarching “true and fair” legal requirement in terms of corporate governance as required by s.393(1) CA 2006. As far as the author can determine, neither the FRS nor any corporate law association, patent attorney or IP association is actively involved in the debate

²¹ M.R. Mathews and A.W. Higson, “Potentially Dysfunctional Impacts of Harmonising Accounting Standards: the Case of Intangible Assets” (2000) Massey University, School of Accountancy Working and Discussion Papers (2000), <http://mro.massey.ac.nz/handle/10179/2536> [Accessed 14 October 2015].

²² T. Chambers, “Value Reporting: A Bigger, More Accurate Picture than Traditional Financial Reporting” (2003), <http://iveybusinessjournal.com/topics/strategy/value-reporting-a-bigger-more-accurate-picture-than-traditional-financial-reporting> [Accessed 14 October 2015].

on the adverse impact of IAS 38 on the accounting treatment of intangible IP assets. The accounting profession continues to control the redirection and growth of the financial recognition of IP assets in the corporate and financial world. IP assets as financial assets “are” what accountants preparing the financial statements by following accounting standards tell us they “are”. If IP assets are not reflected in the balance sheet and are fully expensed as they are undertaken, both the earning and book value of a company’s equity will be understated by the accounting model.²³ Thus, shareholders will potentially be provided with biased (conservative) estimates of the firm’s IP values and of its capability for the creation of future wealth as a result of those IP assets. One aim of this article is to inform shareholders, lawyers, corporate regulators and patent attorneys as to the critical issues that arise directly as a result of the application of IAS 38 to internally developed IP assets. These stakeholders need to more fully appreciate why IAS 38 is generally unhelpful in representing the strategic and future growth value of internally generated IP assets to the company. Shareholders are prevented from obtaining reliable information on the innovative activity of the company, potentially leading to unfair or inaccurate risk evaluations. Given the outcome, the importance of asking the following legal question should not be underestimated.

Do financial statements prepared according to IAS 38 provide a “true and fair view” of IP assets as required by s.393(1) CA 2006?

A company’s annual return includes its financial statements, which are publicly available documents. The rationale for companies to report to shareholders rather than regulators is so that the decision as to the adequacy of the company’s governance is made by those in whose interest the board is meant to act. Section 393 CA 2006 states that the directors must not approve the accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company.²⁴ It provides:

- “(1) The directors of a company must not approve accounts for the purposes of this Chapter unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss —
- (a) in the case of the company’s individual account, of the company;
 - (b) in the case of the company’s group accounts, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.
- (2) The auditor of a company in carrying out his functions under this Act in relation to the company’s annual account must have regard to the directors’ duty under section (1).”

²³ R. Ghafele, “Getting a Grip on Accounting and Intellectual Property”, World Intellectual Property Organization, http://www.wipo.int/sme/en/documents/ip_accounting_fulltext.html [Accessed 14 October 2015].

²⁴ The term “true and fair” was first used in the UK, where it originates, in legislation of 1948. Earlier legislation had used similar phrases. Company legislation dated 1844 required UK companies to “present a full and fair balance sheet”, though the meaning of this phrase was never defined. A company was required to keep “full and true accounts”. By 1900 the auditor was required to state whether the balance sheet was “properly drawn up so as to exhibit a true and correct view”. This phrase was retained until 1948.

If the financial statements provide shareholders with a potentially biased (conservative) estimates of the firm's value (equity) and its capability to create wealth in the future (current earnings), this implies that current accounting statements fail to provide an unbiased (true and fair) view of the company's financial position. This is an important corporate governance issue because it is the board of directors that has primary responsibility for the corporation's external financial reporting functions.

The role of the auditor is to independently review the company accounts for accuracy and compliance with accounting standards. Section 495(3) CA 2006 requires the auditors to prepare a written report and clearly state whether, in the auditor's opinion, the annual accounts

- “(a) Give a true and fair view —
 - (i) In the case of an individual balance sheet, of the state of affairs of the company as at the end of the financial year,
 - (ii) In the case of an individual profit and loss account, of the profit and loss of the company for the financial year,
 - (iii) In the case of group accounts, of the state of affairs as at the end of the financial year and of the profit or loss for the financial year of the undertakings included in the consolidation as a whole, so far as concerns members of the company
- (b) have been properly prepared in accordance with the relevant financial reporting framework; and
- (c) have been prepared in accordance with the requirements of this Act (and, where applicable, Article 4 of the IAS Regulation).”

In other words, the auditor's role is to independently verify that the company's financial statements are a fair representation of the company's finance performance and financial position. As the requirement to prepare accounts which show a true and fair view is a *legal* requirement, what is true is a question of fact and what is fair is a question of law for the courts to determine. The “true and fair” concept has been part of English company law for decades and is central to accounting and auditing practice. However, there is no statutory definition of the phrase “true and fair view” either in the CA 2006 or in other UK legislation. Nor is the expression “true and fair view” defined in the accounting literature. However, the phrase has been the subject of the UK's Financial Reporting Council (FRC) research and case law which will be discussed in the paragraphs to follow.

The practical effect of s.393 is that all UK company directors have a duty to ensure that the financial statements are free from material misstatements and faithfully represent the financial performance and position of the company. In larger companies, the managing director and the chief financial officer are crucial participants, and boards usually have a high degree of reliance on these officers to ensure the integrity and supply of accounting information. These corporate officers oversee the internal accounting systems, but they are dependent on internal management accountants for the actual supply of the information. The independent auditors must then consider and expressly state in their audit report whether or not company directors have fulfilled their responsibility to prepare “true and fair”

financial statements. Professionally qualified UK accountants and auditors are members of professional accounting bodies which adopt codes of professional conduct and standards of professional, ethical and technical conduct and competence. Professional accounting associations typically require their members to adhere to the accounting standards set by the relevant standard-setting bodies, e.g. the IAS and the International Financial Reporting Standards (IFRS). This means that, to avoid professional negligence, accountants must apply IAS 38 to intangible IP assets. Conversely, if they apply IAS 38 in carrying out their accounting duties, they will not be professionally negligent even if the financial statements do not provide a “true and fair” view of the company’s IP assets.

In terms of corporate governance and company law, the supply of accounting information forms a crucial link enabling shareholders and finance providers to monitor directors. Imperfections in the financial reporting process will cause imperfections in the effectiveness of corporate governance. Company law disclosure requirements have largely evolved to protect shareholders and creditors. The long-held public policy motive is that increased transparency will prevent fraud largely due to over-valuing corporate assets. However, with respect to internally developed IP assets, is not the issue the potential *undervaluing* of those corporate assets (due to the lack of strategic contextual information) that would enable users to assess the quality and future potential benefits of the corporate IP assets? Is the company being transparent enough in relation to its corporate IP assets? Is the failure of companies to report on IP information and strategy placing them at a disadvantage? Crucially, will this potential undervaluing of the corporate IP assets impede the directors’ legal duty to promote the success of the company? A modern approach to the corporate reporting of IP information is relevant to the concept of enlightened shareholder value discussed further below.

The evolving concept of corporate governance under the rubric of “shareholder value” and promoting the success of the company

From a legal perspective, corporate governance principles may prefer the view that useful and relevant narrative IP information is more important than accounting information that is high in the traditional value of objectively and reliability, but low in terms of relevance and usefulness from a corporate reporting perspective. With commercial companies, success is measured by money—the relevant aim is to increase the value of the company.²⁵ The CA 2006 sets out directors’ duties in ss.171–177 with the aim of amending the common law to bring it into line with the expectations of the modern business world. This concept is known as enlightened shareholder value (ESV). It is argued that the expectations of the modern business world should include the scale of value dependency on intangibles and IP assets and their management by the directors of UK companies. The role of directors is critical to any system of corporate governance.²⁶ Broadly speaking, the directors’ common law duties were originally designed to prevent negligence and to make sure that they put the company’s interests ahead of their own. The

²⁵ S. Worthington, “Reforming Directors’ Duties” (2001) 64 *Modern Law Review* 439, at p.8.

²⁶ A. Keay, “The Duty to Promote the Success of the Company: Is it Fit for Purpose?”, University of Leeds School of Law, Centre for Business Law and Practice Working Paper (August 2010), p.3, <http://www.law.leeds.ac.uk/assets/files/research/events/directors-duties/keay-the-duty-to-promote-the-success.pdf> [Accessed 14 October 2015].

new statutory duties have the same objectives.²⁷ Section 172 CA 2006 codifies the common law duty of “good faith” and is a core duty based on the equitable fiduciary duty formulated by Lord Green MR in *Re Smith and Fawcett Ltd.*²⁸ The Master of the Rolls said that the directors of a company must act

“*bona fide* in what they consider — not what a court may consider — is in the interests of the company, and not for any collateral purpose”.²⁹

“Good faith” is an abstract term that comprehends a sincere belief or motive without any malice or desire to defraud. It stems from the English translation of the Latin term “*bona fide*”, and courts use the two terms interchangeably.

In *Item Software (UK) Ltd v Fassihi*,³⁰ Arden LJ further clarified that

“the fundamental duty to which a director is subject, is the duty to act in what he in good faith considers to be to the best interests of his company ... The duty is expressed in these very general terms, but that is one of its strengths: it focuses on principle not on the particular words which judges or the legislature have used in any particular case or context. It is dynamic and capable of application in cases where it has not previously been applied but the principle or rationale of the rule applies. It reflects the flexible quality of the doctrine of equity”.³¹

However, s.172(1) is novel in that company directors also have a clearly articulated duty to promote the success of the company; the section which states:

- “(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to —
- (a) the likely consequences of any decision in the long term;
 - (b) the interests of the company’s employees;
 - (c) the need to foster the company’s business relationships with suppliers, customers and others;
 - (d) the impact of the company’s operations on the community and the environment;
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct; and
 - (f) the need to act fairly as between members of the company.”

This section codifies the common law and is intended to promote the concept of ESV. Accordingly, the directors are expected to act in good faith in the interest of the company and have a duty to try to find what has the highest probability of promoting the success of the company. In discharging the above duty, directors are required to “have regard” to a non-exhaustive list of factors which include but are not limited to: long-term consequences; employee interests; the need to foster

²⁷ A. Keay, *The Enlightened Shareholder Value Principle and Corporate Governance*, Routledge Research in Corporate Law (Abingdon and New York: Routledge, 2013).

²⁸ *Re Smith and Fawcett Ltd* [1942] Ch. 304 CA.

²⁹ *Re Smith and Fawcett* [1942] Ch. 304 at 306.

³⁰ *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; [2005] I.C.R. 450.

³¹ *Item Software* [2004] EWCA Civ 1244; [2005] I.C.R. 450 at [41].

relationships with customers and suppliers; and any impact on the community or environment. The list does not expressly refer to IP assets, but the list is “non-exhaustive” and it is argued that if IP assets are material to the company’s business model then directors must “have regard” to them in discharging their duty. The second limb of s.172(1) innovatively seeks to “capture cultural change in the way companies conduct their business”.³² It is further argued that the modern “creative economy”³³ is one such cultural change. Section 172(1) aspires to make decision-making more “enlightened”,³⁴ advancing the concept of ESV. According to Andrew Keay, “The section may be said to impose a duty on directors to require them to be more inclusive in their decision-making ...”.³⁵

As long as directors act in good faith to promote the success of the company, they will not become liable merely because a decision turns out to have been a bad one. However, s.172(1) needs to be read in conjunction with s.174 CA 2006, which imposes a duty to exercise reasonable care, skill and diligence. If a company’s IP assets are material to financial performance, then directors have a legal duty to exercise reasonable care, skill and diligence in managing them. It follows that shareholders need sufficient reported information to enable the directors’ stewardship of those assets to be assessed. Consider this: what if the problem for innovative companies that internally generate IP assets is that those assets are invisible on the company’s balance sheet (owing to the required application of IAS 38) and as a result the company’s potential to succeed is hindered by an inability to finance its activities? This issue is more likely to affect small companies than large ones that have other non-IP assets to use to secure finance. The key question is whether the directors have fulfilled their duty to the company and have acted in a way that they consider in good faith would be most likely to promote the success of the company. Hypothetically, for the director of a micro company with no other assets save a small portfolio of internally generated patents coupled with his duty to promote the success of the company, the question of the accounting treatment required by IAS 38 to treat the IP as expenditure rather than valuable corporate assets with future growth potential should play on his mind. Turning to the list of matters to which the directors must have regard in promoting the success of the company, the most relevant provisions are s.172(1)(a), the likely consequences of any decision in the long term; and s.172(1)(b) the interests of the company’s employees. This is because the directors need to ensure that the company is appropriately financed to carry out its operations. If a core activity of the company’s operations involves internally generating IP assets as the company’s sole or main assets, then a central matter for the directors should be to endeavour to ensure that their value is reflected in a true and fair way in the company’s accounts in order to secure the finance needed to commercialise them and generate a profit for shareholders. Inadequate finance will have a detrimental effect on the long-term consequence of the success of the company, its profits and the job

³² Department for Trade and Industry, *Companies Act 2006: Duties of Company Directors* (Ministerial Statements (2007)), <http://webarchive.nationalarchives.gov.uk/20090609003228/http://www.berr.gov.uk/files/file40139.pdf> [Accessed 14 October 2015].

³³ The creative economy refers to a range of economic activities concerned with the generation or exploitation of knowledge and information (intangibles).

³⁴ Keay, A. *Supra* 22 at p.11.

³⁵ A. Keay, “Good Faith and directors duty to promote the success of the company” (2011) 32 *Company Lawyer* 138.

security of its employees (if any). The list of matters to which the directors must have regard, as set out in s.172(1), is not exhaustive and it is argued that directors should “have regard” to the impact of intangible IP assets on the company’s potential success.

Another hypothetical question—what if the directors of a company that internally generates IP assets, in carrying out their duty under s.172, genuinely believed that the company was being disadvantaged as a result of adhering to IAS 38? In other words, that applying IAS 38 to their IP assets does not result in a true and fair view of those assets? What would be the outcome if they refused to sign off the accounts under s.393 because they were unconvinced that the accounts gave a true and fair view of the company’s IP assets and their value creating and growth potential for the company? To answer these questions, an evaluation of the legal research that has been undertaken in connection with judicial consideration of the concept of “true and fair” financial statements is necessary.

What is “true and fair” corporate reporting with respect to intangible IP assets?

Prima facie the word “true” in this context is taken to mean that the company’s financial statements are factually correct and have been prepared according to applicable reporting frameworks such as the IFRS, and that they do not contain any material misstatements that may mislead users. “Fair value” is primarily a legal concept and is intended to estimate a fair or reasonable or equitable (to use legal terminology) amount. It is not necessarily intended to reflect a likely historic cost, market or income approach to valuation. The essence of fair value, from a legal point of view, lies in the desire to be equitable to all parties. Fair valuation in respect of an IP asset is the amount that will fairly compensate an owner who is deprived of the economic enjoyment of the IP asset where there is neither a willing buyer nor a willing seller. In 2012, the UK’s FRC published its policy stance and clarification of the phrase “true and fair” view.

FRC research as to the meaning of “true and fair view”

On its website the FRC announced:

“The most authoritative statement as to the meaning of ‘true and fair’ have been legal opinions written by Lord Hoffmann and Dame Mary Arden in 1983 and 1984 and also by Dame Mary Arden in 1993 (‘the Opinions’). Since those Opinions were written, there have been some significant changes in accounting standards and company law which have led to some to question whether the views expressed in those Opinions remains applicable.

In these circumstances, the FRC concluded that it would be helpful to its preparers, auditors and users of financial statements if it commissioned a further legal opinion to ascertain whether the approach to ‘true and fair’ taken in the Opinions requires to be revised. The FRC instructed Martin Moore QC and his Opinion is now published on the FRC website.

In his Opinion, Mr Moore has endorsed the analysis in the Opinions of Lord Hoffmann and Dame Mary Arden and confirmed the centrality of the

true and fair requirement to the preparation of financial statements in the UK, whether they are prepared in accordance with international or UK accounting standards.

Directors must consider whether, taken in the round, the financial statements that they approve are appropriate. Similarly, auditors are required to exercise professional judgment before expressing an audit opinion. As a result, the Opinion confirms that *it will not be sufficient for either directors or auditors to reach such conclusions solely because the financial statements were prepared in accordance with applicable accounting standards* [emphasis added].

The FRC believes that this Opinion is an important confirmation of a key contributor to the integrity of financial reporting in the UK.³⁶

The relevance of the true and fair concept has been squarely confirmed by the FRC in its short four-page report *True and Fair*, published in July 2011.³⁷ Further, the importance of the true and fair view in both UK GAAP and IFRS has been reaffirmed by the Accounting Standards Board and Auditing Practices Boards, according to FRC Press Notice 338. The very first page of the FRC's *True and Fair* report reads:

“In this note we discuss the continuing primacy of the true and fair requirement and its relevance to preparers, those charged with governance and auditors.

Preparation of accounts

In his Opinion Martin Moore notes, in relation to the gradual shift over time to more detailed accounting standards, that ‘It does not follow ... that the preparation of financial statements can now be reduced to a mechanistic process of following the relevant standards without the application of objective professional judgement applied to ensure that those statements give a true and fair view, or achieve a fair presentation.’

This professional judgement is all important.³⁸

The report specifically mentions that this applies to “making judgements about valuation, aimed at giving a true and fair view”, as well as “standing back at the end of the accounts process and making sure the accounts overall do give a true and fair view”.³⁹ Nevertheless, the FRC issues the following cautionary statement about “true and fair” and accounting standards, and warns that departing from accounting standards should only be taken in extremely rare circumstances:

“Where the accounting standards clearly address an issue, but the answer does not seem to accord with ‘common sense’ in a particular case, the solution is normally proper disclosure.”⁴⁰

³⁶ Financial Reporting Council, <http://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/True-and-Fair.aspx> [Accessed 14 October 2015].

³⁷ See Financial Reporting Council, “True and Fair” (July 2011), <http://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.aspx> [Accessed 14 October 2015].

³⁸ FRC, *True and Fair* (July 2011), p.1, <http://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.aspx> [Accessed 14 October 2015].

³⁹ FRC, *True and Fair* (July 2011), p.2, <http://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.aspx> [Accessed 14 October 2015].

⁴⁰ FRC, *True and Fair* (July 2011), p.3, <http://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.aspx> [Accessed 14 October 2015].

In its concluding remarks, the FRC offers the following advice to preparers, directors and auditors in order to ensure that accounts in the UK continue to provide high quality information: “Always ... stand back and ensure that the accounts as a whole do give a true and fair view.”⁴¹ This advice necessarily applies to directors who have responsibility for managing material corporate IP assets on behalf of the company’s shareholders.

The existence of internally generated IP assets is certainly not an extremely rare occurrence in commerce. On the contrary it is increasingly common among innovative corporations. While IAS 38 clearly addresses the accounting treatment of intangible assets, in the author’s opinion the outcome of the application of IAS 38 (for the reasons detailed earlier and especially for companies whose corporate IP is their main asset) does not seem to accord with “common sense”. In such a case, according to the FRC, *the solution is proper disclosure*. The FRC’s solution anticipates the need for companies to provide additional narrative disclosures in relation to their intangible IP assets when the relevant accounting standards that do not produce a true and fair view. The opinion from Martin Moore QC clearly sets out that the “true and fair” requirement is an over-arching concept, and is not the same as compliance with accounting standards. In other words, even where a company complies with an accounting standard, if the accounts fail to provide a “true and fair” view, then they are inadequate. Is the adequacy of the financial accounts a question for the accountants or for the courts? In the author’s opinion, where IP assets are recorded simply as an “expense” in the company’s balance sheet without further supplementary narrative disclosure, the value of those IP assets may be under-reported for corporate governance purposes and thus neither true nor fair—a legal issue. In addition, the Framework for the Preparation and Presentation of Financial Statements (the Framework) by the IASB is explicit in reference to the “true and fair” requirement and provides as follows:

- “12. It is inherent in the nature of the true and fair concept that financial statements will not give a true and fair view unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed. Such expectations change over time and the Board seeks, through its accounting standards and other authoritative pronouncements, both to respond to those expectations and to influence them. The Statement of Principles may therefore be expected to contribute to the development of the concept.
13. The Statement of Principles does not, however, define the meaning of true and fair — it is detailed legal requirements, accounting standards and, in their absence, other evidence of generally accepted accounting practice itself, that normally determine the content of financial statements. Nevertheless, as the Statement is a set of high level accounting principles designed to help in setting standards, it has the true and fair view concept at its foundation. Its insistence on

⁴¹ FRC, *True and Fair* (July 2011), p.4, <http://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.aspx> [Accessed 14 October 2015].

relevant and reliability as prime indicators of the quality of financial information is just one example of this.”⁴²

Applying these principles, if internally generated IP assets are off balance sheet then the financial reports do not provide a true and fair view of those assets, because the information is insufficient in quantity and quality to satisfy the reasonable expectations of the shareholders to whom the financial reports are addressed. The new UK GAAP adopts IAS 38 and will determine the methods of recognising intangible IP assets and measuring them for the financial reporting elements of the company’s annual return commencing on or after 1 January 2015.⁴³ This will result in the continuation of the “mechanical application” of IAS to intangibles and IP assets and perpetuate a lack of transparent reporting of quantitative and qualitative IP information to shareholders.

Is there a role for the courts or a test case to depart from IAS 38? A UK court may have regard to accounting standards such as IAS 38, but is not legally bound by them in assessing the legal question as to whether a company’s financial statements give a true and fair view. The court may take into account other evidence and expert evidence presented by accountants, lawyers and patent attorneys in arriving at their decision. Accounting experts are likely to argue that IAS 38 is appropriate because in their opinion there is no way to reliably measure the probability that the expected future economic benefits attributable to the asset will flow to the entity using accepted accounting methodology. Further, they will point out that tangible assets and intangible assets should be treated the same. However, lawyers know that fair is not always equal and what is equal is not always fair. It can be fair to treat situations (or for our purpose, asset classes) differently, yet equitably. By way of analogy, imagine that a teacher puts a chocolate bar on the top of a tall bookshelf and asks the tallest and the shortest students in the class to try to get it. That would be equal but unfair. If the shorter student got a boost up, that would not be equal, but it would be fair. Presently, the financial reporting playing-field is not level where internally generated IP assets are concerned when compared with tangible assets. This information asymmetry is not only an accounting problem; increasingly it is a corporate governance problem.

True and fair IP information—principles versus rules and substance over form

The debate about the purpose and significance of the “true and fair view” corporate reporting concept is associated with two well-known dichotomies in accounting: principles versus rules and substance over form.⁴⁴ Given the accounting standards currently used and likely to remain in place in the foreseeable future, narrative disclosure is recommended as the best means to supplement and complement the traditional financial statements. Shareholders and other outsiders need more IP information to enable them to assess three things:

⁴² Accounting Standards Board, *Statement of Principles for Financial Reporting* (December 1999), pp. 10–13, <https://www.frc.org.uk/Our-Work/Publications/ASB/Statement-Statement-of-Principles-for-Financial-Re.pdf> [Accessed 14 October 2015].

⁴³ IAS 1 was adopted by Directive 1725/2003.

⁴⁴ C.N. Albu, N. Albu and D.J.A. Alexander, “The True and Fair View Concept: A Case Study of Concept Transferability” (14 April 2009), p.3, SSRN, <http://ssrn.com/abstract=177000> [Accessed 26 October 2014].

1. whether the company directors, who have the legal responsibility for managing the IP assets, are ensuring a reasonable return on those assets;
2. the control of directors' acting in their own self-interest as opposed to acting in the interests of the company⁴⁵; and
3. whether the directors' use of the IP assets is contributing to the success of the company.

In terms of transparency, it is vitally important to recognise, account for and report on IP assets owned by the company as a matter of good corporate governance. Hrishikes Bhattacharya, formerly Professor of Finance at the Indian Institute of Management, confirms that:

“Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise. Disclosure of this information, together with a commentary by the management is encouraged.”⁴⁶

The way in which IP assets are reported is fundamental given their potential strategic value to the majority of modern companies. The next section introduces existing UK legal corporate disclosure requirements and how these apply to a company's IP assets.

Corporate IP information disclosure—existing legal requirements

As long as there is no place for internally generated intangible IP assets on balance sheets, corporate law needs to ensure that such increasingly valuable assets, for which directors are responsible, are not ignored or hidden from shareholders and the public. If traditional accounting for IP is an ineffectual gatekeeper of the status quo because accounting statements cannot adequately document how IP assets relate to business performance, then the law must step up and confront the challenge of communicating this information. As it stands, there is a material disconnect between the entirety of the company's intangible IP assets and the legal requirements of corporate financial reporting. The chartered accountant and author Sir Russell Kettle said:

“A true and fair view implies that all statutory and other information is not only available but is presented in a form in which it can be properly and readily appreciated.”⁴⁷

More recently, the 2014 *IP Valuation* report acknowledged the poor situation as to the recognition, measures and disclosure of IP and concluded that the present reporting and information frameworks are in urgent need of updating⁴⁸

⁴⁵ *York Building Co v MacKenzie* (1795) 7 Bro. P.C. 42; 3 E.R. 432.

⁴⁶ H. Bhattacharya, *Banking Strategy, Credit Appraisal and Lending Decisions: A Risk-Return Framework* (Oxford: Oxford University Press, 2010), p.464.

⁴⁷ R. Kettle, “Balance Sheets and Accounts under the Companies Act, 1948” in W.T. Baxter (ed.), *Studies in Accounting* (London: Sweet & Maxwell, 1950), p.17. Sir Russell Kettle (1887–1968) was a member of the Cohen Committee on Company Law Amendment.

⁴⁸ Commission, *Final Report from the Expert Group on Intellectual Property Valuation* (March 2014), p.44.

The Strategic Report and IP information disclosure

Do existing UK corporate disclosure laws reach far enough to include intangible IP assets in the context of accounting methods currently used? ⁴⁹ An affirmative answer to this question is more likely owing to the new strategic reporting process. Since October 2013 the strategic report has replaced the business review and forms part of a company's annual return pursuant to ss.414A–D Companies Act 2006.⁵⁰ The purpose of the strategic report is to inform shareholders and help them to assess how the directors have performed their duty to promote the success of the company. It is separate from the directors' report and must be separately approved by the board of directors. According to the FRC, the overriding objective of narrative corporate reporting is to provide information on an entity, and insight into its main objectives and strategies, and the principal risks it faces; and to complement, supplement and provide context for the relevant financial statements.⁵¹ Reporting on corporate assets should be reflective of the value they provide to the business in the medium to long term and keep pace with developments in the creative economy.⁵² The information in the strategic report will also assist shareholders to determine whether directors have ensured a proper return on the corporate IP assets. It is crucial to make IP information as easy as possible for shareholders to understand so that the "invisible" value of IP assets can be seen to inform decision-making. Improving the quality of non-financial corporate IP information available to shareholders and external stakeholders is one way to assist companies to overcome the distortion of the IAS 38 related financial calculations concerning the fiscal value of their IP assets.

The CA 2006 (the Act) sets out different levels of reporting depending on the type of company. Section 414A of the Act requires all companies that are not small⁵³ to prepare a strategic report. For a financial year in which the company is a parent company, and the directors of the company prepare group accounts, the strategic report must be a group strategic report relating to the entities included in the consolidation.⁵⁴ The extent of disclosure required by a company will vary according to the type and size of company. However, the FRC's guidance does not differentiate on this basis. Material information that is necessary for an understanding of the development, performance, position or future prospects of the entity⁵⁵ should be disclosed in the strategic report, irrespective of the existence or otherwise of an explicit statutory disclosure requirement. This is a mandatory requirement. With respect to intellectual capital (which comprises intangible IP assets) the FRC states the following:

⁴⁹I. McClure, "The Perfect Storm: Corporate Disclosure, Shareholders, and the Importance of Intellectual Property" (7 July 2010), IP Prospective, <http://www.ipprospective.com/portfolio-potential/the-perfect-storm-corporate-disclosure-shareholders-and-the-value-of-intellectual-property/> [Accessed 14 October 2015].

⁵⁰ Companies Act (Strategic Report and Directors' Report) Regulations 2013.

⁵¹ Financial Reporting Council, "Rising to the Challenge: A Review of Narrative Reporting by UK listed Companies" (2009), p.1. The FRC reviewed the annual reports of 50 UK listed companies focusing on content, communication and clutter.

⁵² International Integrated Reporting Committee Discussion Paper, "Towards Integrated Reporting: Communicating Value in the 21st Century" (September 2011), http://theirc.org/wp-content/uploads/2011/09/IR-Discussion-Paper-2011_spreads.pdf [Accessed 14 October 2015].

⁵³ Companies Act 2006 s.414B.

⁵⁴ Companies Act 2006 s.414A(3).

⁵⁵ The FRC guidance uses the broader description "development, performance, position or future prospects of the entity" rather than the description "development, performance or position of the company's business contained in the Act, unless the latter is more appropriate in a specific context".

“Off-balance sheet resources

Most companies discuss their employees; given this is now a requirement ‘to the extent necessary’ this is not surprising. However, only 36% go beyond this to discuss other intangible assets such as brands, intellectual capital and natural resources. The off-balance sheet assets are often some of the most important to a company’s future success; a comprehensive discussion of ‘performance and position’ should include this aspect as well as the resources on the balance sheet.”⁵⁶

The FRC’s guidance implicitly refers to IP assets. The strategic report is therefore an integral part of the annual report in relation to the directors’ stewardship of the company’s IP assets; disclosure made within the company law framework substantially increases the legitimacy and authority of the IP asset information disclosed. Further, filing a strategic report with Companies House will also assist directors to demonstrate how they have met their duty to promote the success of the company under s.172 Companies Act 2006.

Listed companies and IP information disclosure

The Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013 require quoted companies to make new disclosures about human rights, gender diversity and greenhouse gas emissions in their strategic report. This took effect for financial years ending on or after 30 September 2013. To date, IP information disclosure has not been specifically considered as a special topic for mandatory disclosure although in light of the issues raised in this article the author is of the view that there is a good case that it ought to be.

In addition to the strategic report, companies listed on the London Stock Exchange (LSX) for example must comply with even more onerous mandatory disclosure as they subscribe to the Disclosure and Transparency Rules (DTR).⁵⁷ The DTR are designed to promote prompt and fair disclosure of relevant information to the public investor market. According to the LSX, “This helps to encourage investor confidence and maintain Europe’s deepest pool of capital”. In this respect, prospective investors in the company should have public information on the company’s intangible IP assets which allows them to come to their own valuation judgments. Relevant information is “price-sensitive” information that would be likely to have a significant effect on the share price in the short term. While compliance with DTR is mandatory for listed companies, it is a matter for a company’s board of directors to exercise its collective judgment to determine when to disclose significant inside IP asset information, typically applying the “reasonable investor test”. The DTR are aimed at preventing market abuse, and thus disclosure of appropriate IP asset information to the market could even be daily if necessary to comply. It seems that while the traditional accounting system may not be coping with the fluctuations in value inherent in intangible IP assets, the DTR mandate that listed companies must cope with disclosing “price sensitive information” in narrative form or risk their shares being suspended from trading.

⁵⁶ FRC, “Rising to the Challenge” (2009).

⁵⁷ UK Corporate Governance Code (September 2014) and the Stewardship Code (September 2012) also apply.

Even if the price sensitive information relates to corporate IP, they must still “comply or explain”.⁵⁸

In summary, existing UK corporate disclosure laws do reach far enough to include intangible IP assets where IP assets are material to the company’s financial performance and position. At present, however, the IP asset disclosure culture in the UK is weak owing to directors’ perceived need for secrecy and the fear of losing competitiveness.

Directors’ accountability for IP information disclosures

A further important reason why directors are reluctant to disclose additional qualitative narrative information regarding corporate IP assets is that they will then be held accountable for that information. There are severe legal consequences for any failure to report “fairly” so as not to mislead under the CA 2006. On the other hand, remaining silent on the issue of corporate IP assets is also problematic as directors are also liable for material omissions. A director is liable to compensate the company for any loss it suffers as a result of the omission of anything legislatively required to be disclosed.⁵⁹ Consequently, directors have difficult decisions to make regarding the scope of the company’s IP asset disclosure. As a starting point, one needs to ensure that the narrative disclosure aligns with the numeric intangibles figure in the financial statements in order to make the value of the IP assets to the business more transparent. If the intangibles figure on the balance sheet has increased or decreased significantly from the previous year or reporting period, the company needs to explain why. Basically, directors always need to “explain the money”.⁶⁰ Both the directors and the independent auditors should consider whether the figures for intangibles in the accounts and the corporate narrative in the strategic report are in alignment.

The costs involved in disclosing IP information

Directors will also be concerned about the cost of gathering, verifying and substantiating the IP information, as well as specialist adviser fees. The costs tend to grow with increased disclosure. Typically, this is a greater problem for smaller companies with fewer resources. Small innovative companies have a greater incentive to reduce uncertainty by disclosure, as demonstrated by the information asymmetry caused by IAS 38 and IP assets being off balance sheet and thus invisible to the financial world.⁶¹ Nevertheless, in modern corporate markets, greater transparency and non-financial indicator disclosure are central to increasing shareholder value. The following example illustrates a global company’s approach to the stewardship and strategic management of its valuable IP assets. Frans van Houten, CEO of Royal Philips, one of Europe’s biggest and most successful global

⁵⁸ J. Denoncourt, “Financial Reporting for Intangibles: why intangibles remain invisible” (17 August 2014), IP finance, <http://ipfinance.blogspot.co.uk/2014/08/financial-reporting-for-intangibles-why.html> [Accessed 14 October 2015].

⁵⁹ Companies Act 2006 s.463(2).

⁶⁰ Denoncourt, “Financial Reporting for Intangibles” (17 August 2014), IP finance, <http://ipfinance.blogspot.co.uk/2014/08/financial-reporting-for-intangibles-why.html> [Accessed 14 October 2015].

⁶¹ This implication has been supported in a study by K. Ahmed and J.K. Courtis, “Associations between Corporate Characteristics and Disclosure Levels in Annual Reports: A Meta-Analysis” (1999) 31 *British Accounting Review* 35.

companies, gave the keynote speech at the IP Business Conference in Amsterdam in June 2014, explaining how the company's IP assets create shareholder value:

“Our total portfolio now consists of 64,000 patents, 46,000 trademarks, 93,000 design rights and 4,700 domain names ... So it's clear that we have got some high-quality IP. But why have we got it, how did we get it and what do we do with it? ... For each business, it is all about the alignment of business strategy, R&D strategy and IP strategy ... Another strong asset is our Philips brand, currently valued at more than \$9 billion US dollars. The head of IP&S,⁶² Brian Hinman ... reports to Jim Andre, who is my Chief Strategy and Innovation Officer in our Executive Committee. He's not reporting to the Chief Legal Officer or General Counsel, no, I have my CIPO⁶³ report directly to my head of Strategy and Innovation, at the very heart of our company's business ... Philips IP&Standards has developed great valuation models, so we can put a financial value on all those benefits of IP that are not directly monetary. IP&S has five main remits: IP Creation, IP Value Capturing, IP Value Contribution, IP Counselling and representing Philips in IP matters in the public domain, including work on technical and public standards.”⁶⁴

This type of narrative qualitative IP information absolutely complements the quantitative financial figure assigned to intangible assets on the company's group accounts. However, the 2013 Royal Philips annual report governed by the law of the Netherlands does not set out intangibles or IP assets as a separate item in the table of contents. Group Financial Statement Note 12 to the accounts deals with intangible assets excluding goodwill on p.160, and Company Financial Statement Note A deals with intangible assets on p.193.⁶⁵ Apart from the notes to the accounts, on p.90 there are two paragraphs under the heading “Philips IP & Standards”. The first is merely contextual introductory IP strategy information; the second paragraph states:

“IP&S⁶⁶ participates in the setting of standards to create new business opportunities for the Healthcare, Consumer Lifestyle and Lighting sectors. A substantial portion of revenue and costs is allocated to the operating sectors. Philips believes its business as a whole is not materially dependent on any particular patent or license, or any particular group of patents and licenses.”⁶⁷

As a result of the last sentence quoted above, arguably a shareholder has no express IP asset information on which to assess Royal Philips' IP asset value story, strategy, management or stewardship of those assets in the medium to long term. While it may be true and fair for Royal Philips to say that its business as a whole is not materially dependent on any particular IP asset or licence or groups thereof, in the author's opinion the substantial value residing in the company's IP portfolio merits

⁶² Intellectual Property & Standards.

⁶³ Chief intellectual property officer.

⁶⁴ Speech by Frans van Houten at IP Business Conference (24 June 2014), <http://www.newscenter.philips.com/main/standard/news/speeches/20140624-speech-by-frans-van-houten-at-ip-business-conference.wpd> [Accessed 14 October 2015].

⁶⁵ Royal Philips Annual Report 2013, p.193, http://www.philips.com/philips/shared/assets/Investor_relations/pdf/PhilipsFullAnnualReport2013_English.pdf [Accessed 14 October 2015].

⁶⁶ Intellectual Property & Standards.

⁶⁷ Royal Philips Annual Report 2013, p.90 http://www.philips.com/philips/shared/assets/Investor_relations/pdf/PhilipsFullAnnualReport2013_English.pdf [Accessed 14 October 2015].

additional disclosure for corporate governance stewardship purposes. Further, Royal Philips' claim that it is not materially dependent on any particular IP or licence would be much more difficult for less substantial businesses or for companies in other sectors such as pharmaceuticals (whose business model is more reliant on valid patent protection) to sustain. Even so, Royal Philips demonstrates that, apart from the three paragraphs quoted above and two notes to the accounts, narrative disclosure concerning its valuable IP assets to complement the financial statements is largely absent in the annual report. No IP asset risk or enforcement or infringement litigation is reported. Nothing is said about how the company manages confidential information (knowhow). Royal Philips' largest shareholders are sophisticated enough and have the resources to undertake patent, trade mark and design searches and to monitor stock exchange announcements to arrive at a reasonable understanding of the strategic value Royal Philips' IP assets. But many other smaller shareholders are not so able. On the other hand, the author is not suggesting a company report on every single patent, trade mark or design family or licence. Clearly this would be excessive unwarranted clutter. In contrast, however, a more appropriate level of information regarding Royal Philips' IP management and strategy could be disclosed, given that what is reported to shareholders is less than that provided by the CEO in his speech to the IP Business Congress 2014. In the author's opinion, a level of disclosure in line with the extent of information disclosed in relation to the company's employees, for example, would be a minimum level to aim for. Nevertheless, credit where credit is due: Royal Philips has a dedicated executive vice-president and chief strategy and innovation officer on its board of directors, whose corporate responsibilities include strategy, innovation, design and sustainability. This is positive in terms of overall IP asset management and stewardship. Royal Philips is of course a Dutch company, not subject to UK law. This example has simply been used to illustrate the point regarding the paucity of IP asset, strategy and risk information disclosed generally from the perspective of investor protection and corporate governance. The example highlights the tip of the iceberg. In the author's opinion, if Royal Philips were a UK company, the type of IP information expressed by the CEO Frans van Houten to the IP Business Conference would be highly relevant to disclose to shareholders in the strategic report. Further, if a UK public company's business model is based on exploiting IP assets (e.g. pharmaceutical products protected by patents and trade marks) and it refrained from providing narrative information about its patent and trade mark portfolios in its strategic report, then it could well be argued that the company should not be soliciting investment from the public on investor protection grounds. Rather, it might consider changing its corporate status and revert to a private company status with reduced corporate reporting obligations.

In fairness to company directors, more guidance is needed to identify the type of disclosure and how, what, when, where and how much to disclose with respect to the valuable intangible assets they manage on behalf of the company. There is minimal if any bespoke guidance on corporate intangibles reporting published by the regulators. So, although mandatory legal disclosure requirements relevant to corporate intangible IP assets already exist, the lack of guidance and enforcement by the regulators perpetuates the gap in publicly available information. A broad understanding of an appropriate level of intangible asset reporting has not yet

emerged.⁶⁸ Factors such as the materiality of IP assets to the success of the company, industry disclosure norms, company size, managerial ownership, company age, and the business and technology lifecycle will impact on the extent of the need for enhanced IP asset disclosure. For example, company age has often been seen as a proxy for risk in the sense that established companies are less risky. Kim and Ritter provide evidence that non-financial information is of greater importance in the valuation of younger companies because forecast earnings work better for assessing younger companies than historical earnings do.⁶⁹

The status quo is that non-financial narrative qualitative and strategic IP information have a lower priority than traditional quantitative financial information. However, with respect to IP assets and the modern creative economy, this may be shifting as shareholders and others consider disclosure regarding IP asset management, stewardship and risk factors is insufficient. The ability to evaluate the quality of intangible IP asset disclosures and then assess whether a company has fallen below the standard, in breach of its disclosure obligations and/or directors' duties, is highly specialised and a murky area even for the regulators.⁷⁰ From the perspective of corporate governance it is an issue that merits additional attention. Even so, the UK has some of the highest standards of corporate governance in the world, which makes the jurisdiction attractive to new investment, but there is room for improvement. Companies now regularly report on non-financial indicators such as employees, health and safety, environmental impact and corporate social responsibility.

So far we have focused on decreasing the IP information gap and why companies should “deliver” IP information and strategy in their strategic reports. However, directors need more detailed guidance on how to present the information (e.g. models) as well as the scope and extent of disclosure required to meet minimum corporate disclosure obligations.

IP information models for future narrative reporting

The initial public offering (IPO) prospectus has been suggested as a “role model” for future corporate reporting by Beattie⁷¹ as well as by Cumby and Conrad,⁷² because companies are typically more open and future-oriented in their IPO reporting. Similarly, IP asset reporting needs to be more open and to set out contextual IP management and strategy information as per the Royal Philips example above. Similar to the mandatory strategic report, it is claimed that IPO prospectuses are likely to be especially accurate because companies are liable for any misleading or inaccurate information.⁷³ The IPO model has potential; however,

⁶⁸ Denoncourt, “Financial Reporting for Intangibles” (17 August 2014), IP finance, <http://ipfinance.blogspot.co.uk/2014/08/financial-reporting-for-intangibles-why.html> [Accessed 14 October 2015]

⁶⁹ M. Kim and J. Ritter, “Valuing IPOs” (1999) 53 *Journal of Financial Economics* 409, discussed in R. Beatty et al., “IPO Pricing with Accounting and Comparable Firm Information”, Southern Methodist University (2000), [leeds-faculty.colorado.edu/bhagat/ipo-pricingaccounting.doc](http://faculty.colorado.edu/bhagat/ipo-pricingaccounting.doc) [Accessed 14 October 2015].

⁷⁰ Denoncourt, “Financial Reporting for Intangibles” (17 August 2014), IP finance, <http://ipfinance.blogspot.co.uk/2014/08/financial-reporting-for-intangibles-why.html> [Accessed 14 October 2015].

⁷¹ V. Beattie (ed.), *Business Reporting: The Inevitable Change?* (Glasgow: Institute of Chartered Accountants of Scotland, 1999).

⁷² J. Cumby and J. Conrad, “Non-financial Performance measures in the Canadian Biotechnology Industry” (2001) 2 *Journal of Intellectual Capital* 261.

⁷³ C.M. Daily, S.T. Certo, D.R. Dalton and R. Roengpitya, “IPO Underpricing: a Meta-analysis and Research Synthesis” (2003) 27 *Entrepreneurship Theory and Practice* 271.

further research is needed. The author has developed a “business triage”-style IP asset information reporting model for use in the strategic report, which will be published in the near future.⁷⁴ New IP information disclosure models will emerge. As such, it is timely for the FRC to produce bespoke IP asset information and strategy disclosure guidance for companies.

Charting a course for the future

There is a new and more holistic view for companies to disclose IP information and strategy that escapes the accounting lens, but can be captured by the corporate governance lens. From a legal perspective, financial statements are required to comply with s.393 CA 2006 to provide a true and fair view. This article has adopted a legal approach, as opposed to an accounting approach, to examine whether the application of IAS 38 Intangibles to internally generated IP assets provides a true and fair view of a company’s internally generated intangibles and IP assets, and has concluded that the outcome does not accord with common sense (the information gap). The legal analysis also concluded that there is a good case to be made to depart from accounting standards (whether domestic or international) if the result would be so misleading as to conflict with the objective of the financial statements. On this point, a judicially considered opinion would be welcome as it could pave the way for the development of a new bespoke accounting standard for internally generated intangibles and IP assets.

If and until that happens, it has been argued that to properly appreciate true and fair corporate IP asset information, inadequate IP asset disclosure in traditional accounting statements needs to be supplemented with enhanced narrative disclosure to provide a clearer picture of the IP asset value story to shareholders. Company law and corporate governance principles should take the lead to provide a more holistic and disciplined “true and fair” view of a company’s internally generated IP assets.

As it stands, however, imperfections in both financial and corporate reporting of IP assets cause imperfections in the effectiveness of corporate governance and the protection of a company’s shareholders and other stakeholders. Without qualitative narrative information to complement and supplement the financial statements, it is easier for complex IP assets to either be over-hyped or undervalued, leading to uncertainty for shareholders. IP assets are affected by “context”, and this can be clarified in a narrative disclosure within the company’s strategic report. IP assets are often worth much more than their historic financial value, valuable for any number of commercially strategic reasons. If their value is limited in traditional financial statements owing to the mechanical application of IAS 38 Intangibles, then companies and stakeholders may not be aware of their role and what they can offer in terms of business strategy and performance, ultimately having an impact on investment decisions to sell shares or not invest in the company: in other words, financing the company is adversely affected. Enhanced disclosure of “true and fair” IP information in the Strategic Report section of a UK company’s annual return would promote transparency and serve as an

⁷⁴ J. Denoncourt, “Patent-backed Debt Finance: Should Company Law Take the Lead to Provide a ‘True and Fair’ View of SME Patent Assets?” (Dissertation, University of Nottingham, 2014) award pending.

uncertainty filtering and risk management tool for shareholders. This should lower uncertainty about the future prospects of a company involved in internally generating IP, facilitating a more precise valuation of its IP assets, particularly if such disclosure is monitored annually to track growth. Although the focus of this article has been on the UK, the text draws on practical examples from other jurisdictions. Further, the implications of enhanced IP disclosure are not limited to large public companies. Thus, as a matter of boardroom practice in the UK, EU and internationally, IP asset information must be made more visible in corporate reporting and sensitive to the circumstances that tend to make IP assets more valuable to a company.

One thing is certain: demand for relevant, accurate and timely information regarding modern companies' intangible IP assets will continue to grow. Innovating company directors who hold the view that their company's shares are undervalued should consider whether this is due to the lack of relevant publicly available quantitative and qualitative IP information—the “reporting gap”.⁷⁵ This article has focused on redressing that deficiency. Shareholders, potential investors and other stakeholders are unable to value that which is not made known. The broader implications of enhanced IP asset disclosure for company directors are twofold. First, corporate IP information disclosures need to be both true and fair in accordance with legal principles developed to prioritise the interest of and protect investors. Directors should strive to improve transparency in relation to corporate IP assets to earn the trust of shareholders and other stakeholders in line with existing FRC guidance on off balance sheet assets. Secondly, enhanced IP disclosure will help directors demonstrate how they meet their duty to promote the success of the company under s.172 CA 2006. In short, high quality corporate governance will help underpin the long-term performance of IP-rich companies.

Looking ahead, the EU Innovation Union 2020⁷⁶ strategy is aimed at creating even more valuable IP that will be owned by companies and their shareholders. This article suggests that accountability for IP information disclosure needs additional scrutiny in the public interest to protect those who deal with IP-rich companies. Currently companies (that are risk tolerant) may actually benefit from information asymmetry and the lack of regulatory scrutiny.⁷⁷ Although much has been written about the role of the law in promoting good corporate governance generally, there is much less material available about the standard expected of companies when reporting on their management, stewardship and commercial dealings involving intangible corporate IP assets. Greater regulatory oversight of the disclosure of material IP information is recommended in light of the growing corporate value dependency on IP assets.

At the same time, as directors are accountable for the accuracy of the IP information they disclose they need more detailed guidance on how to report effectively and as required by law in order to avoid liability for misleading or omissions. The sterile language of accounting and company law does not adequately

⁷⁵ Chambers, “Value Reporting” (2003), <http://iveybusinessjournal.com/topics/strategy/value-reporting-a-bigger-more-accurate-picture-than-traditional-financial-reporting> [Accessed 14 October 2015].

⁷⁶ The Innovation Union is the EU strategy to create an innovation-friendly environment that makes it easier for great ideas to be turned into products and services with the aim of economic growth. See http://ec.europa.eu/research/innovation-union/index_en.cfm [Accessed 14 October 2015].

⁷⁷ Kasznik, “Financial reporting for intangibles” (14 August 2014), IP finance, <http://ipfinance.blogspot.co.uk/2014/08/financial-reporting-for-intangibles.html> [Accessed 14 October 2015].

capture the dread many directors feel when having to make a decision about whether the company's IP information and strategy disclosure is true and fair. Disclosing this type of information adds an additional layer of complexity to the corporate reporting system and is a challenge. However, regardless of whether a company reports on its IP, shareholders will make their own decisions. The question then is, "Who is better placed to inform such decisions, the company or other less reliable and accountable sources?" A change of mindset is needed to encourage corporate boards of directors to evaluate and communicate qualitative IP information that goes beyond traditional financial reporting, shedding light on IP value drivers.

While many companies have already adopted good practice in IP information and strategy disclosure, there is a great deal of work still to be done in this underexplored field. Future research and legal scholarship is needed to devise the scope, level and extent of IP information disclosure warranted for different industries, types and size of companies. A cost-benefit analysis of the collecting, verifying and reporting of true and fair IP information would also be beneficial to balance the implications and consequences of such reporting with the wider impact on stakeholders within the innovation ecosystem.