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### Re Comment on FRC Consultation 'Business Reporting of Intangibles: Realistic proposals'

I am writing regarding the FRC's consultation and discussion paper *Business Reporting of Intangibles: Realistic proposals A Discussion Paper prepared by staff of the UK Financial Reporting Council (February 2019)*. By way of background, I am a Senior lecturer and legal researcher in the field of intellectual property, finance and corporate governance at Nottingham Law School. I became an academic in 2004 after a career as a barrister and solicitor in Perth, Western Australia where I was formerly in-house counsel for a publicly listed mining technology company and senior associate heading the Intellectual Property division of the commercial law firm Minter Ellison. *Business Reporting of Intangibles* is an area of research in which I am actively involved in and have produced several peer-reviewed publications detailed further below. My submission seeks to add to the international debate and influence the IASB and FRC and their future work agenda.

#### Question 1

##### Do you agree that it is important to improve the business reporting of intangibles?

Yes. The role of business reporting has expanded well beyond simply reporting financial data and historical information. In 2019, the magnitude of corporate intangibles and intellectual property (IP) assets is of a different order. Investment by UK business in intangible assets (e.g. patents, trade marks, designs, copyright and trade secrets among other things) totaling £137 billion has outstripped investment in tangibles assets of £104 billion by approximately 25%.<sup>i</sup>

Modern investors, shareholders, corporate stakeholders have become more aware of the value of intangibles and IP than previous generations. As such, the activities, actions and ethics of corporate intangibles and IP owners in the UK are increasingly subject to public scrutiny. As shareholders and investors increasingly scrutinise the figures allocated to intangibles, a more comprehensive approach to business reporting, both quantitatively in traditional financial accounts and qualitatively in notes to the accounts and narrative corporate reports, is warranted.

#### Question 2

##### Do you agree that intangibles should be recognised at cost under the two conditions set out in (i)?

Yes, as a general principle of accounting practice, I agree that intangibles should be recognised at cost under the two conditions set out in the FRC report.

Accounting statements provide information that shape a particular understanding of a business. However, accounting principles have traditionally relied on two inherent assumptions: that tangibles rather than intangibles contribute to business performance; and that business depends on arms' length transactions between a willing buyer and a seller. Section 386 of the *Companies Act 2006* (CA 2006) requires every company to keep 'adequate' accounting records. Adequate accounting records must be sufficient, first to show and explain the company's transactions; second, to disclose with reasonable accuracy, at any time, the financial position of the company; and third, to enable the directors to ensure that the accounts they are required to prepare, comply with the relevant laws.

However, there should be flexibility. Providing a figure should be at the discretion of the preparer. Although it may be difficult to estimate the development costs of an intangible at the outset of a project, this will not always be the case. Where it is not difficult to estimate, the intangible(s) should be recognised at cost when reporting. On the other hand, if it is difficult to estimate, the existence of the intangible assets should nevertheless be acknowledged in the notes to the accounts and the rationale for not recognising such intangibles at cost provided.

### **Question 3**

**Do you agree with the assumptions the paper makes regarding measurement uncertainty of intangibles?**

Yes, I agree with those assumptions. On this point the legal requirement of a 'true and fair' view and measurement uncertainty of intangibles is relevant. Section 393 CA 2006 requires that directors must not approve accounts unless they are satisfied they give a true and fair view. The legal 'true and fair' principle moderates and alleviates the issue of the lack of absolute quantitative certainty of present financial value. However, in my view, it is appropriate that a true and fair view comprise and assessment of ALL corporate assets, tangible and intangible. Formerly 'off-balance' sheet intangible assets need to have a visible and transparent place in modern business reporting. The true and fair requirement remains of fundamental importance in the relevant UK accounting standards.

### **Question 4**

**Do you agree that existing accounting standards should be revisited with the aim of improving the accounting for intangibles?**

Yes, existing accounting standards should be advanced, updated and modernised to take greater account of intangibles and IP assets. When managing accounting for innovation, it is important for companies to identify and record intangibles and IP assets as an additional line item in the accountants' spreadsheet, even if they are off balance sheet items, as they will undoubtedly become more important and valuable as the business matures.

#### *Notes to the accounts*

Expanding the use of notes to the accounts would provide additional information on the company's intangibles and IP assets, their history within the entity and potential for future value creation.

If corporate intangibles information could be captured in an accounting line item from the date of incorporation, this baseline of intangibles asset financial and qualitative information will support traceability, integrity, transparency and future disclosures in the notes to the accounts and narrative reporting throughout the business lifecycle.

#### *Enhance the accounting standard to include express reference to technology readiness levels (TRLs) to measure R&D and technology intangibles*

We are in an age that highly values innovation. With respect to intangibles such as R&D and technology, where there is quantitative financial value uncertainty, the accounting standard could be enhanced and advanced through the inclusion of other methods for valuing technological innovation to supplement traditional practice.

For example, the Technology Readiness Level (TRL) system is a well-established method of estimating the maturity of critical technology elements on a scale of one to nine, with nine being the most mature technology. The TRL system was originally developed by the US National Aeronautics and Space Agency (NASA) in the 1980s to assist with the allocation of public funding. The use of TRLs enables consistent uniform discussions of technical maturity across different types of technology. It is a well-established measurement tool to support the assessment of investment and funding risks. The TRL system facilitates cross-sector communication regarding technology and could help to improve transparency and disclosure of intangibles in business reporting.

These measures suggested above would expressly increase the level of transparency and disclosure of corporate intangibles. Accounting is not simply a neutral discipline for business decisionmaking, it sanctions particular distributions of wealth and legitimises commercial relationships.

#### **Question 5**

**Do you agree with the above proposals relating to expenditure on intangibles?**

Yes, I agree with this proposal. It is important to capture the company's expenditure on corporate intangible assets and IP. Quantitative information enables shareholders, investors and other stakeholders to begin to understand and critically examine the directors' stewardship of the corporate intangibles.

#### **Question 6**

**Do you agree with the proposals aimed at improving the quality of information recognised and unrecognised intangibles in narrative reporting?**

Yes, absolutely. I am encouraged that the FRC is exploring the issues arising as a result of the mechanical application of traditional accounting principles to intangibles. Corporate disclosure theory predicts that an increase in the level of disclosure of corporate intangibles and IP assets should reduce information asymmetries, leading to potential benefits such as a decrease in the cost of capital and access to finance; lower interest rates and help to foster increased trust in companies with business models with a high proportion of intangible and IP assets. High quality dialogue relies on robust quantitative and qualitative information. The level of intangible and IP information that should be measured, made transparent and disclosed is a matter for the board of directors. This may involve additional costs to report the metrics suggested. To this end, a cost benefit analysis could be carried out to inform the decision-making of a particular board and company.

The intangibles and IP business reporting gap is inconsistent with the corporate governance philosophy of full and fair disclosure. The traditional methods of accounting appraisal, measures and ratios have worked well with classic asset categories, but are less than optimal in valuing intangible assets. The way in which corporate value is assessed is evolving. I advocate that a minimum level of mandatory disclosure is necessary for large and listed companies. The sheer magnitude of a large or listed company's intangible assets may be material as an independent fact.

An annual audit of the intangibles and IP should be carried out and narratively reported on to reassure shareholders and the company as a whole that these assets are being well-managed. Regular annual reporting on intangibles and IP will likely reveal greater predictability of intangibles and IP value over time.

Further, corporate governance egalitarianism is the doctrine that it is desirable for everyone to have a standard level of information e.g. about a company's corporate intangibles and IP. Providing a framework for more holistic information about a company's intangibles and IP will also reduce the risk of unlawful 'selective' disclosures by listed companies. A 'selective disclosure' occurs when a publicly traded company discloses material information to a single person, or a limited group of people (such as analysts or investors), as opposed to disclosing the information to all investors at the same time, giving rise to the risk of insider trading.

Information regarding the value of intangibles and associated data could also be made available via company companion websites.

#### **Question 7**

**What are your views about how the various participants involved in business reporting could or should contribute to the implementation of the proposals made in the paper?**

*Ensuring appropriate board oversight and reporting of intangibles and IP*

In addition to a governance legal framework for business reporting, transparency and accountability for intangibles, an important feature is to ensure an adequate and appropriate system of controls exists within the company to safeguard intangible and IP assets.

In terms of the effectiveness, directors of intangibles and IP-centric large and listed companies should consider the nature of their R&D, innovation, technology, creative content, brands and trade secrets and how these assets contribute to the business model and value creation.

Company directors will need a minimum level of ability to identify issues relating to intangibles and IP, to enable them to probe, detect and investigate when making business decisions on behalf of the company. In addition to promoting the success of the company, directors are primarily responsible for the prevention and detection of fraud within the company.

Large and listed companies should ensure that at least one appropriately qualified person is appointed and publicly reported as having oversight and responsibility for intangibles and IP assets (e.g. Intangibles and IP manager, Director, NED, a specialist advisory board, external professional advisor etc.).

In order to have effective oversight of intangibles, technology and IP, the board should implement and report on its system of internal intangibles, technology and IP control. However to date, the literature has tended to focus on accounting and the role of financial auditors, and not audits of intangibles, technology and IP. Accountability through monitoring, control and business reporting is a potential solution to the problem of trust in intangibles and IP rights as a form of corporate value.

A high level expert group of accountants, corporate governance specialists, intangibles and IP experts, together with representatives from the regulatory bodies (accounting, markets, Companies House) as well as the UKIPO and government (e.g. UK IP Minister) would be an excellent initiative to elaborate a high level report to further inform the FRC's future guidelines. I would be pleased to be involved in this work.

#### **Question 8**

**Do you use additional information other than the financial statements when assessing and valuing intangibles? If so, can you please specify what additional information you use.**

A marvellous example of a self-made billionaire with a high level of awareness of intangibles and IP assets is Dr Herb Wertheim, an American septuagenarian. He is also the inventor of several optometry patents and has an engineering background. Dr Wertheim uses a simple 'buy and hold' approach to investing in IP-centric technology companies. However, rather than concentrating on the quantitative information reported in traditional accounts, Forbes reports that studies corporate patents and technical literature and bases his technology investments on impressive patent portfolios owned by large companies such as e.g. IBM, 3M and Intel.<sup>ii</sup> Wertheim says he is making a long-term investment in General Electric's (GE)'s IP as he is especially interested in its patented 3-D printing of metal engine parts; the 126-year-old company has more than 179,000 patents. Wertheim is reportedly 'very comfortable with GE because of their technology'.<sup>iii</sup> Dr Wertheim's IP-based approach for choosing which technology companies to invest in illustrates the value of intangibles and IP for investors who use business reporting information.

#### **Question 9**

**Do you have any suggestions, other than those put forward in this paper, as to how improving the business reporting of intangibles might be achieved?**

Yes. Please refer to my additional peer-reviewed literature on corporate reporting of intangibles and corporate IP assets. I would be grateful if these would be included in an updated bibliography to the 8 February 2019 FRC Discussion Paper, in chronological order:

(1) Dr J Denoncourt PhD Thesis 2015

'Patent-backed Debt Finance: Should Company Law Take the Lead to Provide a True and Fair View of SME's Patent Assets?' available at <http://eprints.nottingham.ac.uk/30743/>

Director of Studies: Professor Paul Torremans (Intellectual Property)  
Second supervisor: Associate Professor Sandra Frisby (Insolvency)  
External Examiner: Professor Emeritus Jeremy Philips (Intellectual Property)  
Internal Examiner Dr Andrea Tosato (Secured Transactions).

Abstract:

There is an astonishing lack of quantitative and qualitative public information about corporate IP assets that make it difficult to assess their strategic value (“the IP value story”) and directors’ stewardship of those assets. This thesis argues this is 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 through cross verification with corporate narrative disclosure. The multidisciplinary insights into the transparency corporate problem and how directors fulfil existing obligations to provide “true and fair” IP information under UK law provide an academic audience with a deeper level of legal analysis concerning the intersection between: (1) the IP ecosystem; (2) accounting for intangibles; (3) patent-backed debt finance; and (3) corporate disclosure. Knowledge is advanced with an original business triage style Essential, Desirable & Optional narrative corporate disclosure model.

(2) Peer-reviewed law journal article (2016)

‘True and fair intellectual property information: a corporate governance issue’ (2016) (1) *Journal of Business Law*, pp47-72. ISSN 0021-9460, available at <http://jrep.ntu.ac.uk/id/eprint/28771/>

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.

(3) Peer-reviewed research monograph (2018)

*Intellectual Property, Finance and Corporate Governance* (2018) Routledge Research in IP Series, Routledge Taylor-Francis available at <https://www.routledge.com/Intellectual-Property-Finance-and-Corporate-Governance/Denoncourt/p/book/9781138186255>

Description:

IP law has evolved from being a little pool to a big ocean. Corporate governance needs to respond to society’s rising expectations of directors and boards as the impact of the global intellectual property ecosystem is felt. How can a responsible corporate culture of IP transparency be stimulated to create a rosy future to connect corporate communication with the desires of shareholders, investors and other stakeholders? The astonishing lack of material quantitative and qualitative information companies report about their IP assets makes it difficult for shareholders and other stakeholders to assess directors’ stewardship of those assets – a pressing corporate governance issue in the 21st century. This book advances IP reporting in alignment with the key corporate governance principles of transparency and disclosure. It analyses the juncture between the IP ecosystem; corporate finance and accounting for intangibles; and corporate governance. Patents, mini-case studies and an original business triage style model for assessing IP disclosures are used to illustrate the gaps corporate governance theory needs to address. Focusing on the common law tradition of corporate governance in England and Wales, intangibles and IP reporting developments in other jurisdictions are also explored.

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### **Reception and impact of *Intellectual property, finance and corporate governance* (2018)**

John Ogier, former Head of the Guernsey intellectual Property Office and current Chair of Intellectual Property Awareness Network (IPAN) in London wrote to me in 2018 as follows, 'From a first review, it is an excellent presentation on this developing area of IP finance and related corporate governance responsibilities.' In 2019, Ruth Soetendorp Professor Emerita, Centre for Intellectual Property Policy & Management, Bournemouth University published her review my book and comments as follows:

Ruth Soetendorp (2019) *Intellectual property, finance and corporate governance*, by J Denoncourt, *The Law Teacher*, 53:1, 126-129, DOI:10.1080/03069400.2018.1537610 (November 2018) available at <https://doi.org/10.1080/03069400.2018.1537610> She states:

*'Intellectual Property, Finance and Corporate Governance* is an authoritative and comprehensive text that examines the place of intellectual property (IP) in the context of corporate governance, and gives insightful suggestions as to how it might improve. It is aimed at company directors...It will prove essential reading for anyone teaching or researching corporate governance, finance or intellectual property...Dr Denoncourt acknowledges the paradox of IP being a main corporate asset that is consistently left out of corporate governance and financial analyses. She offers two significant reasons for this gap as the absence of corporate IP culture and management's lack of IP awareness...The UK and EU law regulatory requirements governing corporate reporting are fully covered, with particular attention paid to directors' accountability for IP information disclosures. Conceptual differences are drawn between accounting presentation and corporate disclosure law...The author is in full command of her subject, and an inspiring and innovative facilitator of IP learning. No surprise, then, that she promotes IP education as essential in the professional qualification of everyone responsible for corporate governance. Researchers will be grateful that this under-researched topic receives such deep and wide-ranging treatment here. It should find a place in the library of every institution whose students' successful careers will include involvement in establishing, running or advising commercial enterprises. The author concludes with the modest hope that her book will add to the body of knowledge related to corporate governance and IP and promote the success of innovation companies. I am sure that it will.'

(4) Submission to the US Securities and Exchange Commission

I have also made a submission to the US Securities and Exchange Commission (SEC) and the UK Law Reform Commission. My proposal Security over IP Rights and Corporate Disclosure of IP Rights is noted in Part 4 – Further Potential Projects, Thirteenth Programme of Law Reform, Law Commission (2017) pp 35-36. Available at <https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2017/12/13th-Programme-of-Law-Reform.pdf>

(5) Guest Post *IP Finance Blog* (2018)

I contributed a guest post to the IP Finance Blog entitled, 'Intellectual property, finance and corporate governance' (26 April 2018) available at <http://www.ip.finance/2018/04/guest-post-intellectual-property.html>

(6) Chapter (2019)

J. Denoncourt, 'Corporate Intellectual property, Governance and Board Effectiveness Reviews in Large and Premium Listed UK Companies' in D. Gervais (Ed.) *International Association of Teachers and Researchers in Intellectual Property ATRIP CONGRESS 2018 BOOK (2019)*, under review.

Abstract:

The activities, actions and ethics of UK corporate technology and intellectual property IP owners are increasingly subject to public scrutiny. This chapter examines the role of corporate governance in relation to technology and IP rights owned by large and premium listed companies. The analysis is interdisciplinary and examines how the UK's corporate law framework is beginning to give visibility and transparency to potentially valuable corporate IP assets, the technological innovations and brands they protect. For the first time, the UK Financial Reporting Council's revised 'Guidance on Board Effectiveness' which supplements the 2018 Corporate Governance Code expressly refers to 'intellectual property'.<sup>iv</sup> The Guidance recommends that company boards of directors ask themselves questions on these important company assets when making decisions. The legal requirement for company directors to possess appropriate 'ability' to exercise independent judgement in matters relating to the company's technology and IP is examined. Further, a directors' reliance on the 'business judgment rule', a legal doctrine used as a shield against accountability is critically analysed in the context of technology and IP rights. The composition of the board and the use of advisory technology and IP boards established to advise the main board of directors is analysed, as well as the role of the Chief IP Officer (CIPO).

I would be very grateful if the FRC staff would add the above publications to the literature cited in the 8 February 2019 Discussion Paper Bibliography as I believe they are directly relevant and shed light on the issues raised in the consultation from a corporate governance law perspective.

Thank you for considering my submission, please contact me if you have any questions.

Yours sincerely,

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<sup>i</sup> Goodridge, *Investment in Intangible Assets: Report for NESTA* (2011) NESTA Working Paper No. 14/02, p.15

<sup>ii</sup> M. Berg 'Greatest Investor you never heard of' (19 February 2019) *Forbes*, available at <https://www.forbes.com/sites/maddieberg/2019/02/19/the-greatest-investor-you-never-heard-of-an-optometrist-who-beat-the-odds-to-become-a-billionaire/#199e57b22e8a> accessed on 11 April 2019.

<sup>iii</sup> *Ibid.*