

Reporting on intangibles, a recent survey from Japan

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Purpose

- This paper strives to explain why the Japanese Intellectual Asset-based Management (IAbM) report is more inclined for the SME-financial institution relationship.
- The Japanese Ministry of Economy, Trade and Industry (METI) first focus on the listed company-market actor relationship, however, the overlap between the IC information demand and supply was smaller than expected.

Purpose

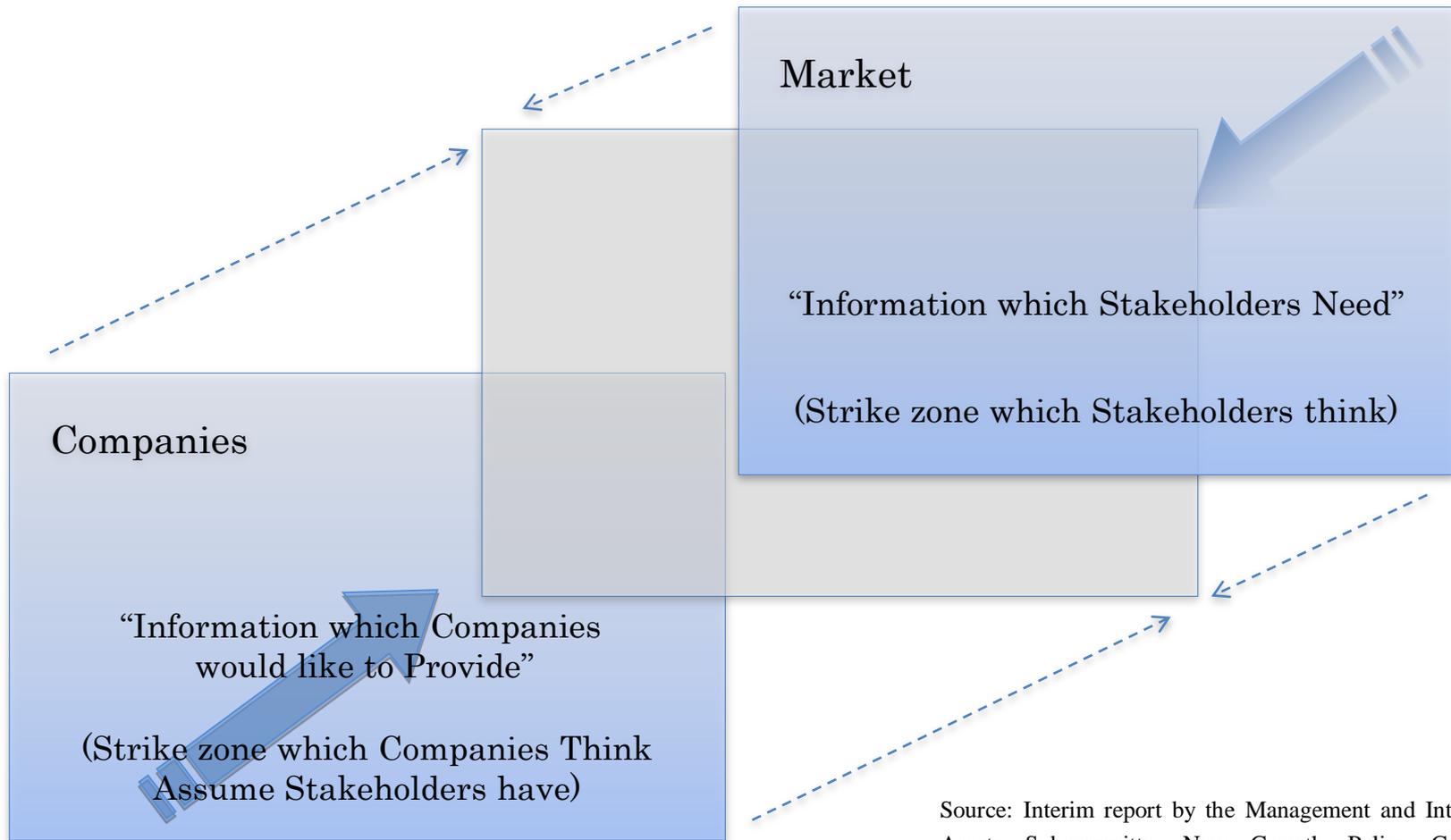
- This paper explains why there was the mismatch for IC information, and also addresses why non-listed SME IC information for financial institutions has been effective in IC disclosures with the previously shown empirical evidence.
- This paper also addresses why non-listed SME IC information for financial institutions has created some movement in the IC field by capturing main actors, such as METI, Organization for Small & Medium Enterprises and Regional Innovation, Japan (OSMERI), and other key IAbM supporters, such as enterprise management consultants and administrative scriveners.

The IAbM report

- The METI published the “Guideline for Disclosure of Intellectual Assets-based Management” in October 2005.
- The guideline’s purpose is to be a communication tool between large firms and stakeholders in the securities market with investors as central actors (Figure 1).

The IAbM report

Figure 1 Stakeholders whose Central Actors are Investors



Source: Interim report by the Management and Intellectual Assets Subcommittee, New Growth Policy Committee, Industrial Structure Council, 2007, pp. 37.

The IAbM report characteristics

- The IAbM report needs the value creation perspective from a managerial viewpoint.
 - First, how the company has accumulated IC resources in the organization, and how they utilize these resources in accordance with their strategy till now.
 - Second, the IAbM needs the strategic view of how companies plan their investments in order to acquire prospective resources that can be used to execute their future business plan.

Mismatch between IC information demander and supplier

- The overlapping intellectual capital information between stakeholders need and company supply has been narrower than ever expected before.
- The disclosure practices of listed companies have not prevailed yet in 2011.

Why has IC report practice not prevailed?

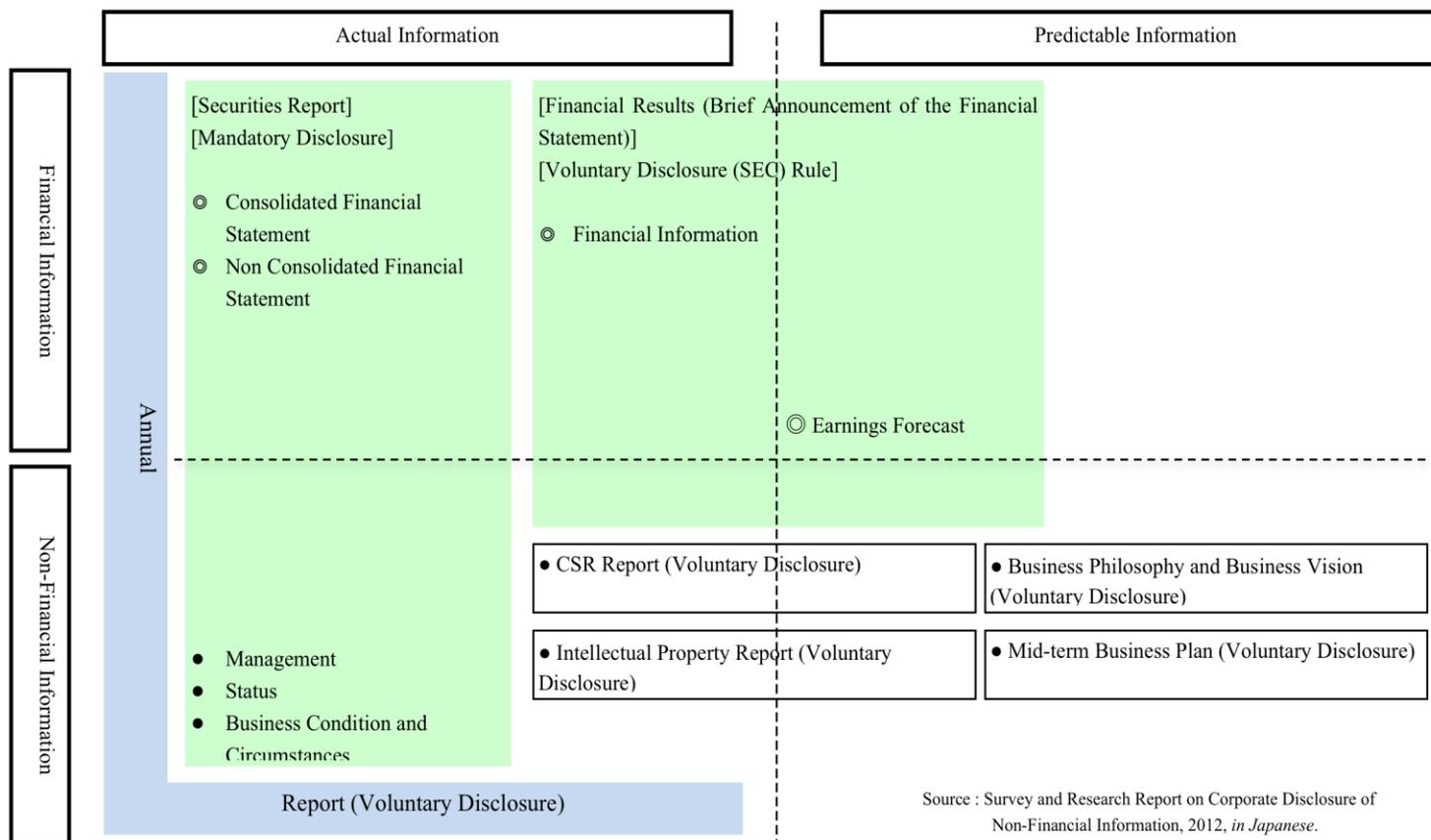
- Japanese listed companies currently disclose a lot of non-financial information via multi-media, such as the CSR report, Business Philosophy and Vision, Intellectual Property Report, and Mid-term Business Plan (Figure 2). All of them are voluntary, especially the CSR report, 439 listed companies disclosed in 2006.
- Sumita (2008) guess[ed] this is because it is difficult to summarize an IAbM report in an existing specific section of a company, whereas IP reports can be handled by the IP section, and CSR reports by the CSR section. The IAbM report requires a corporate manager to grasp the total shape of the organization and establish a clear vision

Why has IC report practice not prevailed? [cont'd]

- Sumita (2008) also suggest[ed] that the IAbM is more easily achieved in SME's, where there is some room for modification in the management system than in big business (ibid., p. 218).
- We can also guess that the companies, especially large listed ones, disclose a lot through multimedia, and they would feel a slight burden if they are required to disclose an additional IAbM Report.

Why has IC report practice not prevailed? [cont'd]

Figure 2 Current Mandatory, Timely, and Voluntary Disclosure Practices of Japanese Listed Companies



Source : Survey and Research Report on Corporate Disclosure of Non-Financial Information, 2012, in Japanese.

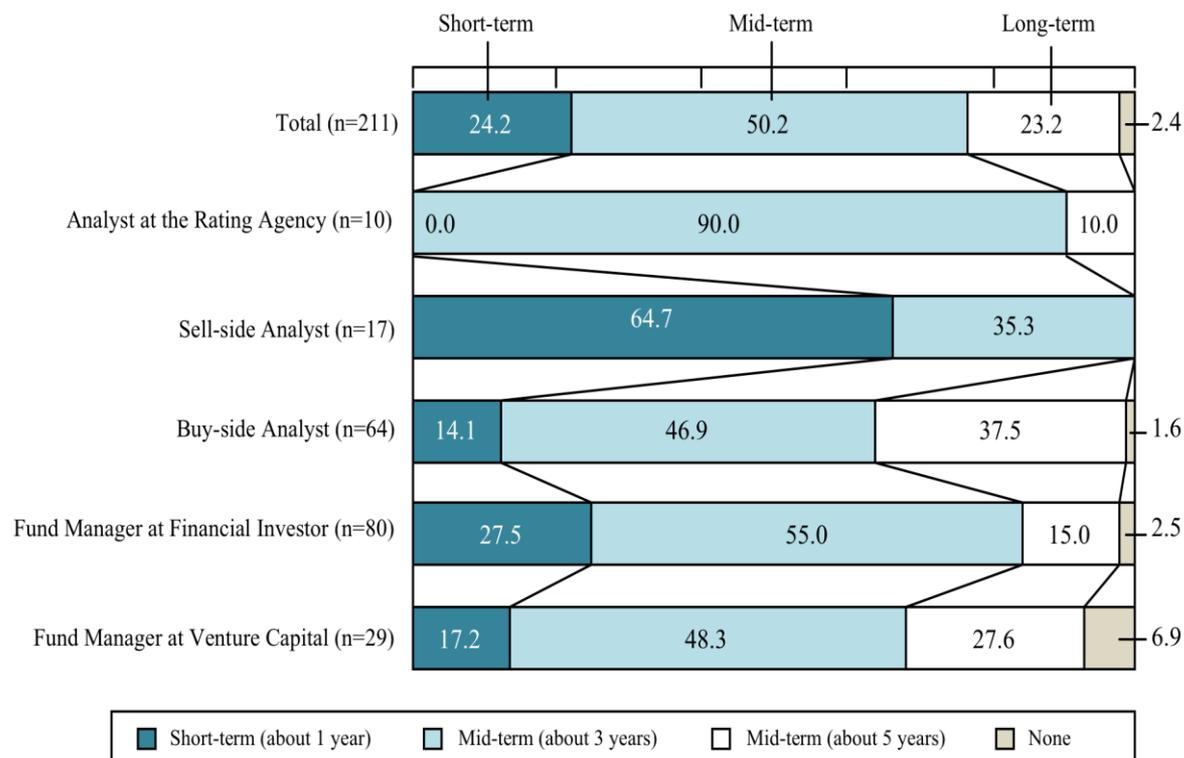
Why has IC report practice not prevailed? [cont'd]

- The central Information demanders, are inclined to short-term viewpoints and place a great importance on the ease of handling and controlling information from a distance (Robson, 1992).
 - A 64.7% of sell-side analysts have a short-term, almost one year, perspective, when they evaluate a company (Panel A of Table 3).
 - The main reason for their short-term view is 1) they are responsible for a short-term evaluation in their company, and 2) their performance is judged within a short-term (Panel B of Table 3).
 - They also attached great importance to the “Ease of understanding,” “Comparability,” and the “Linkage to the corporate value” (Panel C of Table 3).

Why has IC report practice not prevailed? [cont'd]

Table 3 Questionnaire analysis of the Japanese Financial Analysts

Panel A The timeframe of corporate evaluation according to analyst typologies

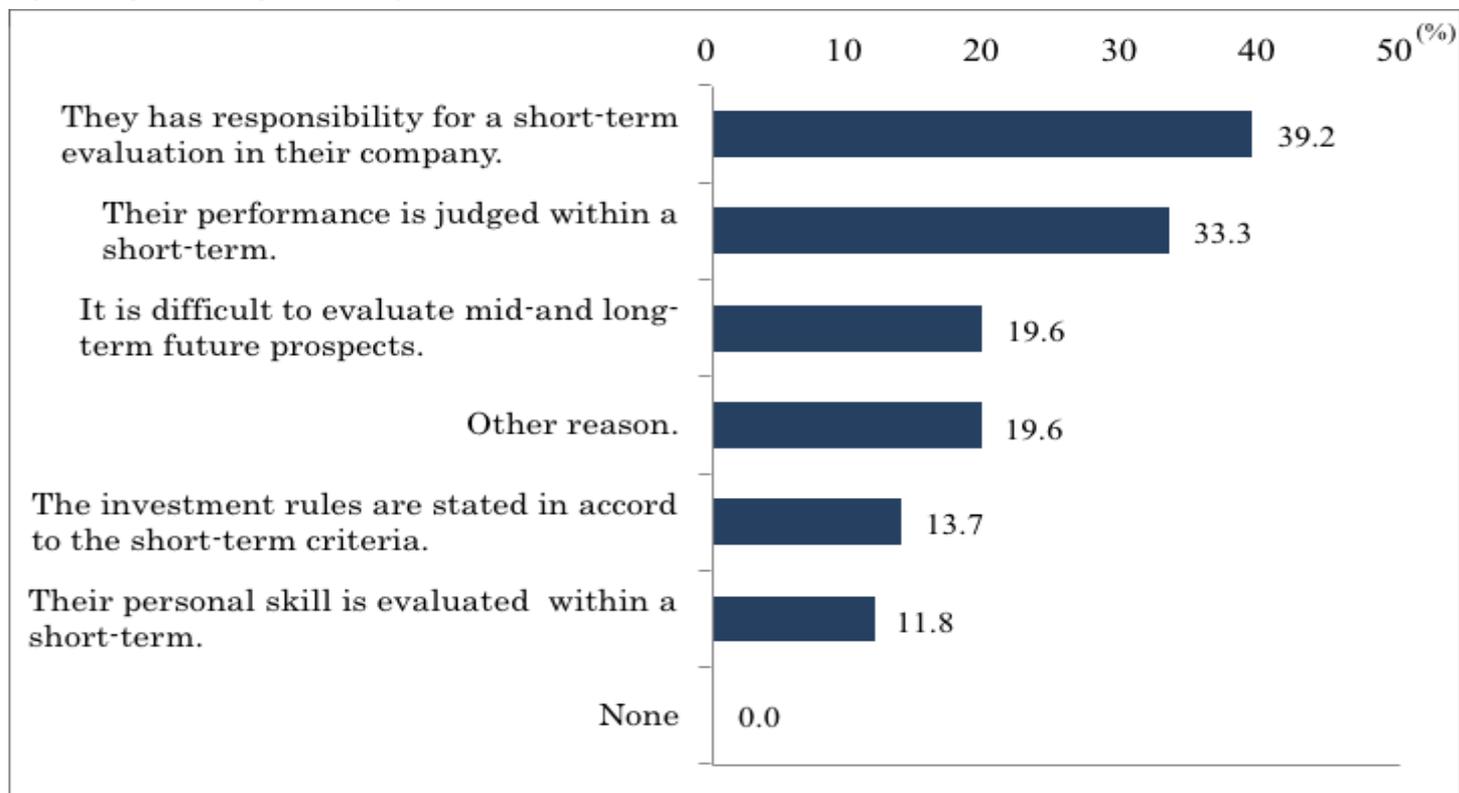


Source: METI (2007, p. 19).

Why has IC report practice not prevailed? [cont'd]

Table 3 Questionnaire analysis of the Japanese Financial Analysts

Panel B Why do financial analysts evaluate a company for the short-term?
 (Multiple responses)

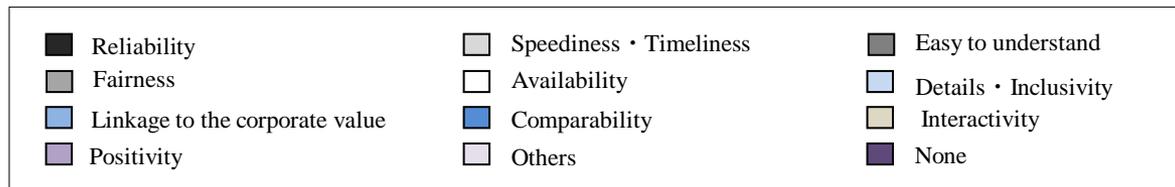
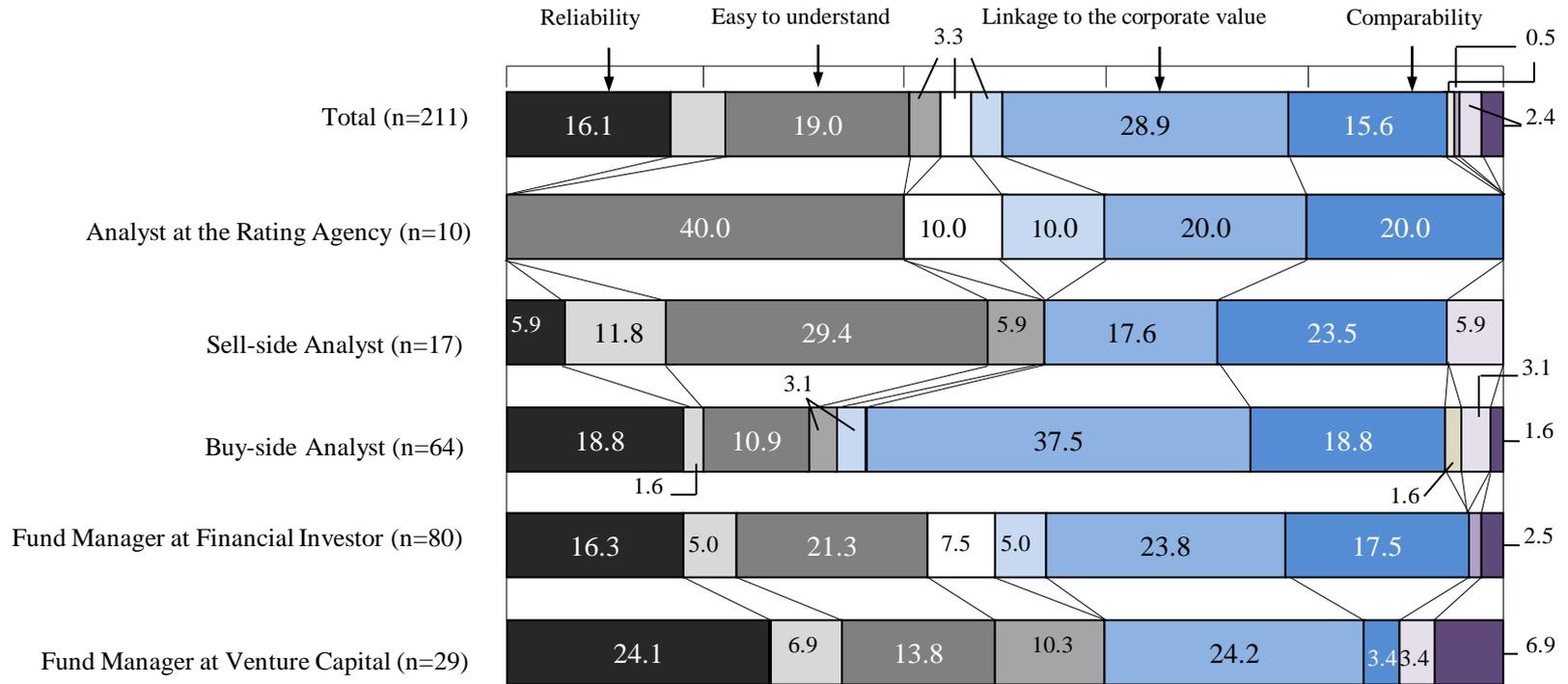


Source: METI (2007, p. 20).

Why has IC report practice not prevailed? [cont'd]

Table 3 Questionnaire analysis of the Japanese Financial Analysts

Panel C Desirable IR attributes for the disclosure of Intellectual Assets-based Management by each type of analysts



Source: METI (2007, p. 22)

Why has IC report practice not prevailed? [cont'd]

- Another questionnaire survey (Sakakibara et al, 2005; Sakakibara et al, 2010), which used 324 Japanese financial analysts, showed as follows:
 - Japanese financial analysts utilize 5 of 15 IC items (corporate strategy, growth opportunity, market share, brand power, and R&D investments) to a high degree (mean score over 4 on the 5 likert scale).
 - They utilize 5 of 15 IC items (corporate strategy, growth opportunity, market share, brand power, and R&D investments) to a high degree when evaluating SME listed companies (Table 4).

Why has IC report practice not prevailed? [cont'd]

- All of the highly utilized 5 items for large listed companies can be gathered from other disclosure media. On the other hand, the first ranked “top management quality” for SME listed companies cannot be gathered through the other media.
- Their utilization of IC information also inclined to management and management strategy, and management policies items.
- These previous analyses' result suggests that difficulties in accessing IC hamper the use of IC.

Why has IC report practice not prevailed? [cont'd]

Table 4 Financial Analy Survey: Degree of use for corporate evaluation

| Japanese Large listed companies | | | | SME listed companies | | | |
|---------------------------------|----------|------|--------------------|---------------------------------|----------|------|--------------------|
| Intellectual capital measures | Category | Mean | Standard deviation | Intellectual capital measures | Category | Mean | Standard deviation |
| Corporate strategy | SC | 4.44 | 0.804 | Top management quality | HC | 4.66 | 0.771 |
| Growth opportunities | RC | 4.32 | 0.782 | Corporate strategy | SC | 4.61 | 0.799 |
| Market share | RC | 4.22 | 0.803 | Growth opportunities | RC | 4.47 | 0.894 |
| Brand power | RC | 4.11 | 0.832 | R&D investments | SC | 4.10 | 0.828 |
| R&D investments | SC | 4.11 | 0.801 | Market share | RC | 4.00 | 0.997 |
| Top management quality | HC | 3.97 | 0.811 | Business alliances | RC | 3.95 | 0.882 |
| Business alliances | RC | 3.81 | 0.799 | Brand power | RC | 3.86 | 0.912 |
| Customer satisfaction | RC | 3.77 | 0.904 | Top executive succession policy | SC | 3.86 | 1.036 |
| Top executive succession policy | SC | 3.34 | 0.945 | Customer satisfaction | RC | 3.82 | 0.933 |
| Employee training | HC | 3.23 | 0.885 | Employee training | HC | 3.49 | 0.999 |
| Corporate governance structure | SC | 3.08 | 1.013 | Employee participation | HC | 3.42 | 1.118 |
| Employee participation | HC | 3.04 | 1.010 | Personnel turnover | HC | 3.35 | 1.085 |
| Personnel turnover | HC | 2.91 | 0.941 | Employee satisfaction | HC | 3.20 | 1.064 |
| Quality assurance systems | SC | 2.89 | 1.066 | Corporate governance structure | SC | 2.95 | 1.013 |
| Employee satisfaction | HC | 2.85 | 0.953 | Quality assurance systems | SC | 2.90 | 1.091 |

Source: Sakakibara et al. (2005, p.8)

The shift from listed company-investor communications to non-listed SME-financial institution communications

- The Japanese government shifted their IC disclosure target from listed company-investor communications to non-listed SME-financial institution communications.
- The Organization for Small & Medium Enterprises and Regional Innovation, Japan (OSMERI), which is affiliated with METI, issued the IAbM manual guideline for SMEs (Intellectual Asset-Based Management Manual for Small and Medium Enterprises; IAbM Manual for SMEs) in March 2007.

The shift from listed company- investor communications to non- listed SME-financial institution communications [cont'd]

- SMEs have the advantage to establish a clear total picture of the management strategy and the shape of the organization (Sumita, 2008, p. 218).
- However, especially for non-listed SMEs, they often lack long-term strategic management views and a well designed organizational structure which progress their strategies. Therefore, the main difference of IAbM Manual for SMEs, compared with the IAbM guideline, is it focuses on the SWOT analysis to capture SME strengths and weaknesses and encourages the re-development of their long-term strategic management view considering their strong and weak attributes (Table 6).

The shift from listed company- investor communications to non- listed SME-financial institution communications [cont'd]

- This shift has been successful thus far.
- A lot of SMEs have been disclosing a IAbM report with the help of the OSMERI, small and medium enterprise management consultants, administrative scriveners, and sometimes local lenders.

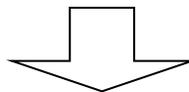
The shift from listed company- investor communications to non- listed SME-financial institution communications [cont'd]

Table 6 The standard procedure of intellectual asset-based management is as follows (See Chapter 4 for details):

« Procedure of intellectual assets-based management »

[Recognizing own company's strengths (stocktake of intellectual assets)]

Firstly, write out the strengths of your own company. SWOT analysis may be effective in this process. This is a stocktake of the sources of your company's strengths and other elements that are important for the SWOT analysis: Analysis method that examines a company's strengths, Weaknesses, opportunities and threats to make an overall assessment. (See Chapter 4 for details)



[Summarizing how the company's strengths lead to profits (scenario making)]

Source: Intellectual Asset-Based Management Manual, OSMERI, 2007, p.12.

OSMERI's acceleration

- Soon after publishing the IAbM Manual for SMEs, the OSMERI initiated the research, focusing on the perception of financial institutions for IC when they lend to the SMEs.
- Why did they focus on SME lending? One reason is Japanese SMEs still rely heavily on loans from the financial institutions, contrary to large companies in Japan.

OSMERI's acceleration [cont'd]

- In parallel Japanese local lenders were under the action “Program for Strengthening Relationship Banking Function,” which was introduced by the Japanese Financial Service Agencies (FSA) in March 2003. This program encouraged regional banks and cooperative financial institutions to move away from transaction lending and move toward relationship lending. “Relationship” in the banking context implies close lender-borrower connections. Therefore, we define “relationship lending” as mutually beneficial banking transactions that occur through the accumulation of non-financial information from closer lender-borrower connections (Yosano and Nakaoka, 2011, p. 5). A lot of IC measures are considered non-financial information, and therefore, introducing the IAbM to SMEs was very appropriate with the FSA’s action program.

OSMERI's acceleration [cont'd]

- In February 2008, OSMERI set up a working group to strengthen financing based on SME IC information, and published two types of research reports.
- One is the “Guideline to Practice the Intellectual Asset-based Management for SMEs.” This guideline recommends that the SMEs disclose a two-page spread IAbM report in order to achieve two main purposes. First, was that the company can easily grasp the summary of their IAbM. Second, was that IAbM supporters, such as enterprise management consultants and administrative scriveners, would be able to have a manual. The ultimate goal was to make this IAbM practice more popular amongst SMEs.

OSMERI's acceleration [cont'd]

- The Second type of research report established was “Surveys and Research Pertaining to Intellectual Asset-Based Finance.” This report involves questionnaire surveys conducted with all Japanese financial institutions, and analyzes in detail their perception of IC information usage and the manner of utilization towards judging a lending decision and supporting SME businesses (Yosano and Koga, 2008).
 - Second report shows that 28% of the financial institutions utilize IC information when they evaluate borrowers in the lending decision.

OSMERI's acceleration [cont'd]

- Similar with Japanese financial analysts, their utilization of IC information is inclined towards management, management strategy, and management policies (Table 8).
- They usually do not use a lot of accumulated IC resources and the IC creation process till now and into the future. IC resources and the IC creation process are the core components that realize the company's management and strategy. However, lenders also think that it is very difficult to access IC information.

OSMERI's acceleration [cont'd]

Table 8 Results of what degree lenders taking into consideration when in financing decisions

| SMRJ Categories | non-financial items | evaluation level* |
|--|--|-------------------|
| | | average |
| manager | personal assets of management | 3.99 |
| | successor's presence | 3.95 |
| | capability of management | 3.93 |
| | character of management | 3.78 |
| | health condition of top management | 3.61 |
| | leadership | 3.49 |
| | age of top management | 3.47 |
| | career of management | 3.41 |
| | concentrative level of the business | 3.37 |
| | the ability of make a pala /idea | 3.36 |
| | career in the sector | 3.35 |
| | networks of management | 3.25 |
| publicity activities | 3.08 | |
| internal/external business environment | business climate/sensitivity | 3.80 |
| | status of competitors | 3.73 |
| | market share / position of the sector | 3.53 |
| business contents | history and track record of business | 3.85 |
| | superiority of technologies | 3.85 |
| | superiority of the main business | 3.84 |
| | superiority of products/services | 3.81 |
| | superiority and brand of products/services | 3.68 |
| | intellectual property (rights) | 3.44 |

* Evaluation level is measured by using five likert scales.

Source: Yosano and Koga, 2008, p. 15.

Table 8 Results of what degree lenders taking into consideration when in financing decisions [cont'd]

| SMRJ Categories | non-financial items | evaluation level* average |
|------------------------------|---|------------------------------|
| customers / suppliers | financing affordable | 4.01 |
| | financing from another main financial institutions | 3.96 |
| | presence of main financial institution | 3.86 |
| | customers and their status | 3.63 |
| | suppliers and their status | 3.42 |
| | relationship with customers | 3.41 |
| | customer satisfaction | 3.32 |
| | relationship with suppliers | 3.30 |
| | sales promotion/advertising campaign activities | 3.12 |
| employees | holders of qualifications/technologies | 3.24 |
| | know-how | 3.23 |
| | the number of employees | 3.13 |
| | turnover ratio | 3.04 |
| | average age of employees (year to year) | 2.95 |
| | incentive system | 2.77 |
| basic of organization | business schedules | 3.95 |
| | affiliates | 3.88 |
| | support system of parent company | 3.66 |
| | management philosophy | 3.45 |
| | business model | 3.43 |
| | corporate brand | 3.32 |
| | In-house mechanism | 3.28 |
| | status of research and development | 3.26 |
| | smoothness of management-labor relations | 3.09 |
| | situations of introduction of the IT system | 3.06 |
| | enhancement level of corporate education | 3.03 |
| | the number of branches | 2.99 |
| | in-house improvement proposal system/the number of improvement executions | 2.87 |
| personal evaluation system | 2.81 | |
| risk management / governance | compliance system | 3.64 |
| | legal risk management | 3.60 |
| | risk management of information leakage | 3.34 |

* Evaluation level is measured by using five likert scales.

Source: Yosano and Koga, 2008, p. 15.

Evidences for non-listed SME-financial institution communications

- The lenders who utilize IC information in regards to management and business significantly, record the higher profitability than lenders who do not.
- The lenders, who utilize IC information in regards to network information, such as customers and suppliers, also record a higher profitability than lenders who do not.
- Utilization of network information is more effective when they are in a highly competitive region (Yosano and Nakaoka, 2011b, p. 34).

Current action from the OSMERI and other related SMEs-local lender relationships

- The IAbM disclosure practice for SMEs is effective for communicating with lenders, and this OSMERI involvement is on-going.
- The OSMERI is currently in the final stage of the IAbM Manual for SME revisions. The upcoming version will provide six different manuals in accordance with the purposes of IAbM disclosure: 1. Venture. 2. Relationship banking. 3. Business succession. 4. Intellectual property. 5. Marketing. 6. Human resource development and recruiting (Table 9).

Current action from the OSMERI and other related SMEs-local lender relationships [cont'd]



Table 9 Utilization and Implementation of Report

How to state the report for their own benefit

The information that should be disclosed is different from the purpose of the statement on Enhanced Value Reporting. Put the company's idea in shape in accordance with their purpose statement and target readers.

| Target Reader | Purpose | Sample of the guidance |
|-------------------------|--|---|
| Customers and Suppliers | Company Information Session | |
| | Business Explanation about the New Product and Service | |
| | Collaboration with Suppliers and Partners | |
| | Financial Results | refer to the theme : Intellectual Property |
| Financial Institutions | Financial Report | refer to the theme : Relationship Banking |
| | Technologies and Business Model | |
| | New Business | |
| | Business Succession | refer to the theme : Business Succession |
| Recruitment | Informally Promised Employment for New Graduates and Mid-Career Recruiting | refer to the theme : Human Resource Development |
| Employee | Business Succession | refer to the theme : Business Succession |
| | Business Operation Improvement | |
| | New Employee Training | refer to the theme : Human Resource Development refer to the theme : Marketing refer to the theme : Venture |

Source: The revised "Intellectual Asset-Based Management Manual for Small and Medium Enterprises,"Forthcoming, 2012.

The IAbM Manual for SME revisions

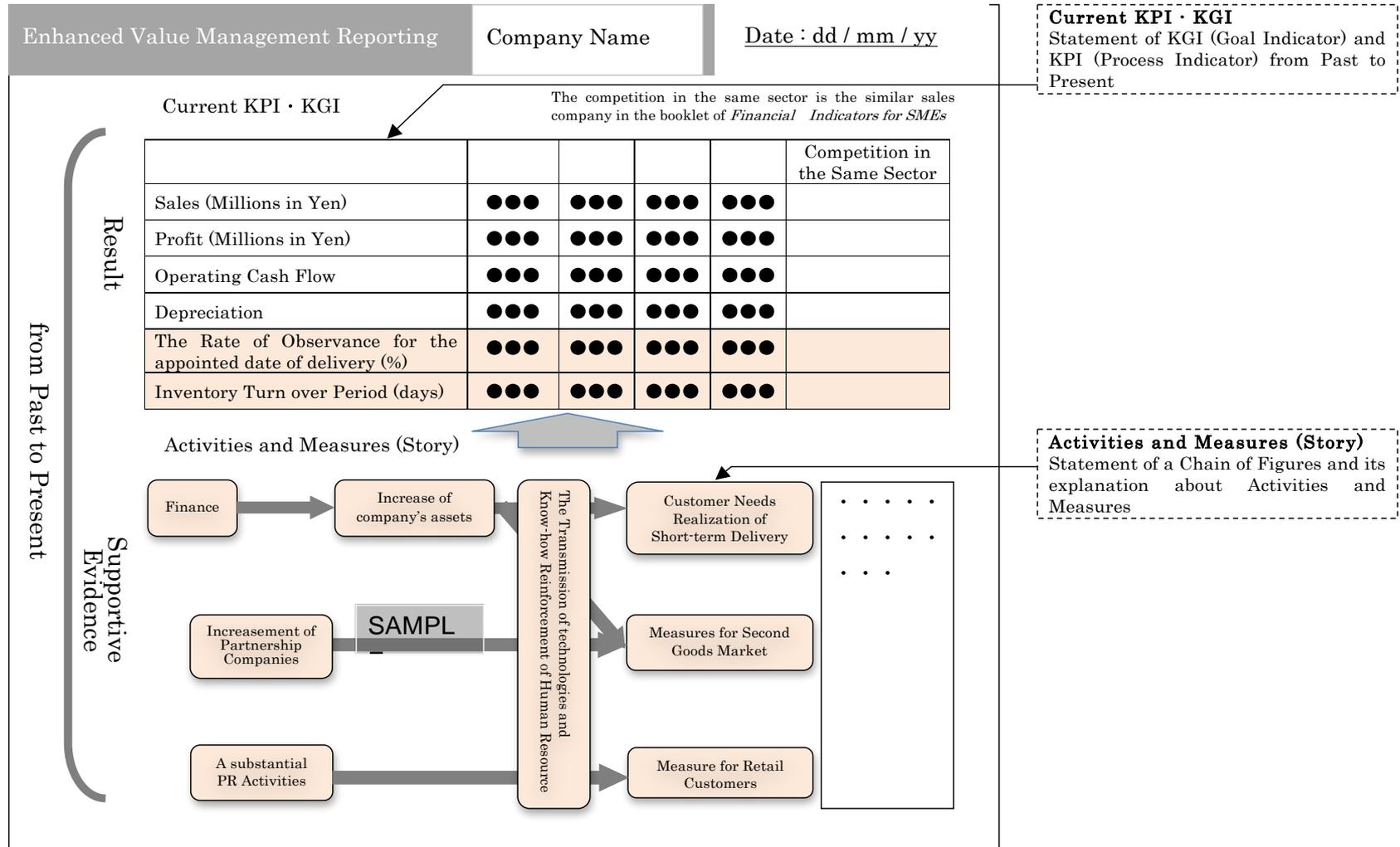
- Relationship lending is still the key purpose for IAbM disclosure and the main characteristic in the revision is that it places a great amount of importance on the relationship between IC measures and the financial result.

The IAbM Manual for SME revisions[cont'd]

- IAbM disclosure makes it difficult for companies to transmit IC resources and information about the IC creation process to stakeholders. Hence, the challenge for this revision was to allow readers to understand current financial results more clearly by requiring the company to disclose the relationship between how current IC resources have been accumulated and how they have been created. In addition, the revision requires the company to disclose the relationship between how it will create new IC resources and their plan to process this creation in the future and the future financial results (Figure 3).

The IAbM Manual for SME revisions

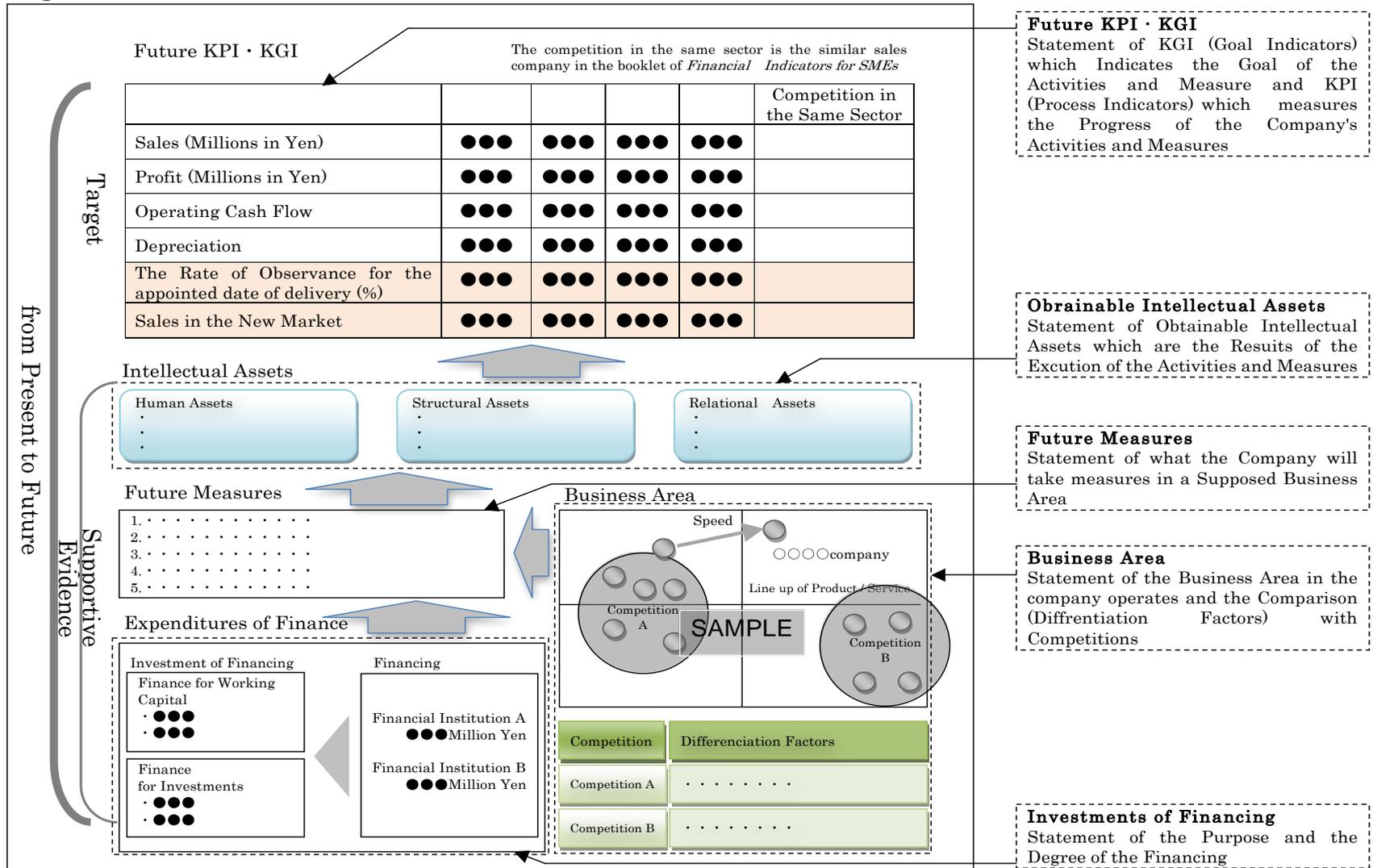
Figure 3



Source: The revised "Intellectual Asset-Based Management Manual for Small and Medium Enterprises,"Forthcoming, 2012.

The IAbM Manual for SME revisions[cont'd]

Figure 3



Source: The revised "Intellectual Asset-Based Management Manual for Small and Medium Enterprises,"Forthcoming, 2012.

Another prominent action

Another prominent action was from the Hyogo Industry Enhancement Center and their local lender membership. Tanyou credit bank has initiated the use of the IAbM to support SME businesses since 2008 in conjunction with the Hyogo Industry Enhancement Center. Tanyou credit bank has supported SMEs to disclose the IAbM report: 9 SMEs in 2009, 11 in 2010, and 22 in September 2011 (Japan Small business research institute, Osaka branch, 2012, p. 43).

Conclusions

- Since the 2000s, the explanation power of financial information has become weaker (Kagaya, 2012; IIRC, 2011), and the earnings volatility has dramatically become broader (Yosano, 2012, forthcoming). Therefore, the surrounding risk circumstances of companies have expanded greatly. It is very clear that the adequate evaluation of default risk and growth opportunities requires other information than financial measures. IC measures are still very prominent candidates.

Conclusions [cont'd]

- In Japan, the main target companies for IAbM practices are SMEs. Communication has been on-going in these non-listed SME-financial institutions, and there's hope that large listed companies will conquer the two main obstacles in the near future. First, is to grasp the long-term management viewpoints and allocate their IC resources in the proper strategic business plan. Second, is to establish adequate KPIs for stakeholders to understand and compare with the competitors in the same section. These actions would enhance the spread of IAbM disclose practices and re-inject the engine of the Japanese economy.