

Intellectual Capital Reporting in Malaysia

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Abstract

This research asserts to achieve two objectives. Firstly, it attempts to examine the extent and major categories of Intellectual Capital Disclosure (ICD) in the Malaysian Initial Public Offering (IPO) prospectuses. Secondly, it examines for the trend of ICD between year 2005 and 2006. Empirical tests are conducted on a sample size of 30 Malaysian companies seeking for listing in the Bursa Malaysia between year 2005 and 2006. The samples are selected from population which is stratified into year of listing. The extent of ICD is measured by "Disclosure Score Index" and content analysis is performed on the IPO of samples selected for year 2005 and 2006.

The result of this research indicates a very low level of ICD among companies undergoing listing exercise. Among the three categories of ICD (i.e. external structure, internal structure and employee competence), external structure is the most reporting category. This result is consistent with the reporting practice in the annual report of listed corporations in Australia, Italy and Spain. In addition, there is a significant difference among the category of ICD. However, there has been no significant difference in the amount of reporting, by category and in total, from year 2005 to 2006 of the IPO prospectuses.

The above results indicate a lack of awareness on the importance of ICD among business corporations in Malaysia. As the economy is getting more competitive and complex, the importance of disclosure of ICD, needs to be acknowledged, in enhancing information for users' decision-making.

1. Introduction

1.1 The Emergence of Intellectual Capital (IC)

Nowadays the world has rapidly moved from an industrial economy, in which economic growth was considered to be mostly determined by the employment of material resources, towards a knowledge-based economy in which wealth creation is associated with the development and maintenance of competitive advantages based on intangible elements that are frequently grouped under the generic term "knowledge". Knowledge is increasingly considered as a commodity and, as such, is subject to economic transactions. The emergence and development of knowledge is facilitated by the advancement of information and communication technologies (ICT).

The advent of computers and information technology (IT) requires the firm to require a more sophisticated work force which relies on expertise more than manual labor, in order to be competitive. IT has changed the way in which the employees work in order to provide better services to the customer. Technology is used to communicate with customers from all over the world due to emergence of globalization, which aid in speeding the delivery process, saving traveling time and costs.

Expertise workforce is considered as a valuable asset of the organization. Developing the know-how and keeping the employee has been critical as a loss of employee means a lost of a chunk of a corporate memory (Brooking, 1996, pp9).

Good relationships established between a vendor and its customers could maintain the existing customers' loyalty and enhance company sales.

The above-mentioned is the result of the transformation of the industrial economy to knowledge economy, which creates intangible benefits in the competitive market environment, which is always named as "Intellectual Capital (IC)".

IC has been defined in various ways in the literature. Brooking(1996) defines IC as the combined intangible assets which enable the company to function and also represents the difference between the book value of the company and the amount of money someone is prepared to pay for it (Brooking, 1997). As quoted in Meritum (2002), IC is generally defined as non-monetary sources of probable future economic profits, lacking physical substance, controlled (or at least influenced) by a firm as a result of previous events and transactions (self-production, purchase or any other type of acquisition) and may or may not be sold separately from other corporate assets.

1.2 Accounting and Reporting of IC

IC does not appear in the traditional financial reports. The reason is because investment in IC does not meet the criteria of recognizing an asset as per the accounting guidelines. An asset is recognized when it is controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise (IAS 16). Since IC does not meet the recognition criteria, as such, it is not reported in the traditional financial report.

Information provided by companies to the financial markets is primarily based on traditional tangible investments in fixed assets, whereas company value is more and more relying on investments in intangible assets. As such, economic losses may occur for persons or institutions that take their decisions on the basis of the reported financial information. In addition, the lack of ability of information systems to adequately reflect intangibles can result in the loss of business opportunities based on intangible resources owned by the firm but not identified or exploited by managers. In that sense, the managers could be blamed for not discharging their responsibility appropriately, thus increasing agency costs to the firm.

In addition, the lack of knowledge concerning the firm's intangibles will be a source of uncertainty over its future earnings, that could translate into an excessive volatility of stock prices. This will lead investors to attach high levels of risk to the firm (a higher cost of capital), thus making it harder for the company to obtain funding for innovative projects and, therefore, affecting its future earnings (Burgman and Roos, 2007 ; Williams, 2001).

Therefore, a common international framework is needed for measuring, reporting and monitoring intangibles. However, the framework may not be adopted as an accounting standard due to its subjectivity of measurement, at least, it allows companies to report their intangibles voluntarily to reduce the uncertainties of financial decision making process & facilitate in efficiency in resources allocation.

1.3 Development of IC Reporting Framework

To date, there has been no international recognition of a method to identify, measure and monitor IC around the world (Guthrie and Petty, 2000 ; Oliveira et al., 2006). As such, accounting standards disallow full disclosure of IC in the financial report. Thus, it understates the value creation by IC to the corporation and management, investment

and credit decision may not be accurate since it's based on a set of financial report which is incomplete.

IC has been suggested to be classified in various forms. No doubt, there has been various definition and classification in the prior literature for the IC components, most of them clustered into meaning which is quite similar to each other. Review of prior literature on the classification of IC indicates that IC could be generally classified in three broad category, namely, "Internal structure", "External structure" and "Employee competence"(Brooking (1996), Meritum(2002), Sveiby & Barchan (2000)).

According to Sveiby & Barchan (2000), "internal structure" consists of a wide range of patents, concepts, models, computer and administrative systems. These are created by the employees and are thus generally "owned" by the organization. "External structure" relates to the relationships of a company with its customers and suppliers. Whereas, "Employee competence" refers to the people's capacity to act in various situations, which includes skill, education, experience, values and social skills.

1.4 Problem Statement

There is growing awareness of the need to report IC information in the corporation's annual report, evidenced by the increase of IC disclosure (ICD) over the relevant period of research in various countries such as in Sri Lanka (Abeysekera & Guthrie, 2003), Australia (Guthrie et al., 2005) and Italy (Cordazzo, 2007). To the best knowledge of the researcher, no similar study has been conducted in Malaysia's corporations to explore for the extent of ICD over the period. The results of the empirical studies in foreign countries cannot be generalized for Malaysian scenario due to economical, political and cultural differences in each country.

Very few papers have analyzed disclosure of IC in initial public offering (IPO) prospectuses (Bukh et al, 2005) as most of the prior research focused on disclosure in the annual report. To the best of my knowledge, no study on the disclosure of IC in the prospectus has been conducted in Malaysia. As the prospectus is more forward-oriented, it may naturally incorporate and disclose considerably more information on the intangible assets of the organization. Therefore, it's worth to study the extent, categories and the trend of ICD for a firm in transition to convert from a privately held corporation into public owned companies.

1.5 Research Questions and Objectives

The following research questions are generated for this study, from the above mentioned problem statement :-

- (1) What are the extent and major categories of ICD in the Malaysia IPO prospectuses?
- (2) What is the trend of ICD in the Malaysia IPO prospectuses?

To summarize, the objective of the current research is to explore the ICD in Malaysian IPO prospectuses. Firstly, this research attempts to examine the amount of ICD, in total and by category, among the going-to-be-listed firm. Secondly, analysis of the trend of reporting from 2005 to 2006 shall be examined.

2. Literature Review & Theoretical Framework

2.1 Motivations for ICD

It is important for the organization to satisfy a broader group of interested stakeholders, whose interests are more than just financial element. As such, there is a phenomena of growing awareness in ICD of various countries, as highlighted in the earlier section. This has raised the importance of non-financial factors in corporate reporting and accountability. The motivations for ICD are better explained by some theories, namely Agency Theory, Stakeholder Theory and Legitimacy Theory.

Agency problem arises when there is a conflict of interests between the management and the investors. Since investors do not normally manage the business, there exists an information gap between the management team and the investors. In order to reduce the gap, Jensen and Meckling's (1976) agency theory provides a framework that links the disclosure behavior to corporate governance. Necessary disclosure is required in order to reduce the conflict of interests and information gap between the management team and the investors.

The Stakeholder Theory is based and tested on the direct effect that the stakeholders may have on the management decisions about a corporation's activities and reporting. It pronounces the existence of a social contract between the corporation and its stakeholders (Roberts, 1992). The degree of firms' adaptation to stakeholders' demands depends on the power of the stakeholders, and the more powerful the stakeholders, the more the company must adapt, i.e. stakeholders are placed as a factor for continued

success of the corporations. As such, it is suggested that organizations will elect to voluntarily disclose information about their intellectual, social and environmental performance, over and above mandatory requirements, in order to meet real or perceived stakeholder expectations.

Legitimacy Theory posits that organizations continually seek to ensure that they operate within the bounds and norms of their respective societies. A company would voluntarily report on activities if the management perceived that this was what the community expected. It relies on the notion that there is a "social contract" between the company and the society in which it operates. The social contract is a way of describing the multitude of expectations that a society has on how an organization should conduct its operations. These societal expectations are not fixed, but change over time. This requires the company to be responsive to the environment in which it operates (Deegan, 2002). In other words, if a corporation wish to change its activities or attempts to alter others' perceptions of its activities, it must be accompanied by reporting. Otherwise, the intended audience will be unaware of what it is the corporation is doing, and its effort in trying to achieve legitimacy, will be problematic.

Claim for legitimacy theory in ICD is evidenced when a company's (e.g. Celemi) reputation enhanced internationally upon publishing its Intangible Assets Monitor, as cited by Sveiby and Barchan (2000). In other words, non-financial disclosure could bring economic benefit to the firm.

2.2 Medium of ICD

Companies have diverse communication channels to voluntarily disclose information through private channels, such as internet sites, conference calls to analysts, press releases, and corporate newsletters and also publicly available information such as disclosure in the annual reports, prospectuses, IC statements and etc (Oliveira et al., 2006).

Annual Report is considered as the most widely distributed of all publicly produced documents of an organization (Williams, 2001) and one of the most important sources of corporate information (Lang and Lundholm, 1993).

In addition, ICD has also been observed in the prospectuses upon new public stock offer (Bukh et al. 2005 ; Cordazzo, 2007 ; Guo et al., 2004). Cordazzo (2007) found that the amount of information on intangibles provided by IPO prospectuses has increased

over the sample period of 1999-2002, which seems to suggest that managers believe this information important in the valuation of their firms by capital markets. The intangibles information contributes to the reduction of information asymmetry, and hence to a reduction of the risk associated with investor decision-making, and a more accurate valuation of firms entering the stock market. Bukh et al (2005) contended that managers of companies involved in taking a company public have incentives to present the underlying information in the most favorable light possible. Thus, the IPO prospectus provides insight into which types of information are selected by a company and its advisors for presenting the company in relation to investors and analysts.

3. Research Method

3.1 Data Collection for ICD

The amount of ICD shall be measured via content analysis of prospectuses by referencing with a checklist of ICD which has been used in the prior literature. The detail will be discussed below.

3.1.1 ICD Framework

This study adopts a framework for the collection of intangible information from Bukh et al (2005), who used it for the study of intangibles disclosure of Danish IPO prospectuses. The framework was developed or modified from Guthrie and Petty(2000); DATI(2003); DMSTI(2003) and Sveiby(1997).

The researcher is of the opinion that the indicators of Bukh et al (2005) is chosen as it incorporates various input from research projects on Intellectual Capital Statements, namely Danish Agency for Trade Industry (DATI) research project in 2003 and Danish Ministry of Science, Technology and Innovation (DMSTI) research project in 2003. The research projects have produced a set of guidelines for the preparation of intellectual capital statements for external publication. In addition, similar guidelines have been applied for research in various countries such as in Australia and Hong Kong (Guthrie et al, 2007), in Italy (Cordazzo, 2007) & in Spain (Garcia-Meca and Martinez, 2005), just to name a few. This indicates that this guideline is widely accepted by nationwide researchers and suitable to be adopted for disclosure related research on annual reports and also IPO prospectuses.

Before finalizing the framework for use in this study, the researcher has reviewed through the list of indicators to identify for any mandatory disclosure items for IPO. Mandatory

disclosure items as required by the Securities Commission shall be deleted from the list to ensure the list consists only the voluntary information for the concern of this study of which is focusing on voluntary reporting of IC. In addition, the checklist is reviewed and deleted for any item which is not relevant to Malaysia environment. The original disclosure checklist adopted from Bukh et al.(2005) contains 78 items, classified in six dimensions, as shown below. However, upon review of the researcher, it is noted that fifteen items shall be deleted from the checklist due to above mentioned reasons. As such, the current disclosure framework consists of 63 items, as summarized below:-

<u>Dimension</u>	<u>No. of item (Bukh et al, 2005)</u>	<u>No. of item (current research)</u>
<u>(1) Employee Competence</u>		
1. Employees	27 items	22 items
<u>(2) External Structure</u>		
2. Customers	14 items	13 items
<u>(3) Internal Structure</u>		
3. Information technology	5 items	5 items
4. Processes	8 items	7 items
5. R&D	9 items	4 items
6. Strategic statements	15 items	12 items
	-----	-----
	37 items	28 items
	-----	-----
	78 items	63 items
	=====	=====

The detailed breakdown of items in each dimensions, is tabulated in (Appendix I).

3.1.2 Disclosure Index

Content analysis on IPO prospectuses will be the main method which will be used to collect data on the extent of IC disclosure of Malaysian IPO.

In an attempt to measure the extent of intangibles disclosure provided in IPO prospectuses, a disclosure score index (DSI) is computed. This index relates the number of indicators that an IPO prospectus contains to the total number of indicators given by the framework for collection of intangibles information. This method of collection of voluntary disclosure items have been commonly used in prior literature (Bukh et al, 2005 ; Chau and Gray, 2002 ; Chow and Wong-Boren, 1987; Cordazzo, 2007 ; Ho and Wong, 2001 ; Meek et al, 1995). The formula to compute DSI is as follows :-

$$DSI_j = \sum_{i=1}^{m_j} \frac{d_{ij}}{N}$$

This index measures the level of disclosure on intangibles for a company j , where $N=63$ is the total number of indicators in the framework; d_{ij} is equal to 1 if indicator i is disclosed, and 0 otherwise; and m_j is the number of indicators disclosed by company j .

If the extent of ICD on employee competence needs to be determined, then the above DSI formula, $N=22$, whereas $N=13$ for measure of ICD for external structure component, and $N=28$ for measure of ICD for internal structure component.

This research that applies the method of content analysis will acknowledge two assumptions, as in consistent with prior literature of voluntary disclosure of corporate social responsibility. Two assumptions are generally used in the corporate social reporting literature, which utilized content analysis as the basis of measuring the corporate social responsibility manner of a corporation (Unerman, 2000). Firstly, it is assumed that higher number of corporate social reporting signifies the importance of the items being disclosed. Secondly, corporations that are aware of corporate social responsibility issue are those that will discuss them as well as act on them. In other words, the corporate social involvement as reported in the annual reports reflects the level of socially responsible manner of the corporations. As such, in this research, it is to be assumed that the higher number of IC reporting signifies the importance of IC to the corporation.

3.2 Sample

Secondary data will be collected from reviewing the IPO prospectuses of companies listed in the Bursa Malaysia in the year of 2005-2006. The amount of companies listed was 79 in 2005 and 40 in 2006 (source : www.bursamalaysia.com).

The population is being stratified into 2 categories by year of listing. Thereafter systematic sampling is used to select 30 samples. The summary of samples is tabulated below.

Table 1 : Summary of companies by sector

Sector	Number of companies listed in	
	2005	2006
Consumer Products	1	1
Industrial Products	7	1
Plantations	0	1
Reits	0	1
Technology	9	6
Trading/Services	2	1
Total	19	11

4. Results And Discussion

4.1 Extent Of Icd

The overall ICD for all three categories, namely employee competence, internal and external structure has been very minimal, being less than 30% for all categories of disclosure, as tabulated below.

Table 2 : Disclosure of Intellectual Capital

Categories	Mean disclosure (as proportion to 1.00)
External structure	0.24
Internal structure	0.20
Employee competence	0.10
Overall ICD	0.17

External structure has been the highest reporting item, followed by internal structure and employee competence is the least reporting item among the components of intellectual capital. There is a significant difference among the category of reporting. The extent of category reporting of 2005 and 2006 IPO similar to the ones reported in

the 2001 annual report of top 20 profit making Malaysian public listed companies (Goh and Lim, 2004), i.e. the amount of reporting is highest for external structure and the least reporting is on the employee competence category. The same practice of category reporting can be observed in various countries such as in the annual reports of companies in Australia (Guthrie et al., 2007), Italy (Bozzolan et al., 2003), Spain (Garcia-Meca and Martinez, 2005) and in the IPO of Portugal (Oliveira et al., 2006).

However, annual report in Sri Lanka (Abeysekera and Guthrie, 2003) disclosed highest amount of reporting in external structure, followed by employee competence and lastly internal structure. Hong Kong companies (Guthrie et al., 2007), on the other hand, disclosed more in internal structure, followed by employee competence and lastly external structure. Even, Italian IPO observed in 1999-2002, has the highest reporting item in the employee competence category, followed by external structure and lastly internal structure (Cordazzo, 2007).

In Italy, it has been observed that the practice of ICD by category of their annual report varies with that disclosed in the IPO. The IPO shows employee competence as the highest reporting category, whereas, external structure has been regarded as the highest reporting category in the annual report.

It can be concluded that the extent of reporting by category is being practiced differently in various countries. However, most countries reporting concentrated mainly in the external structure, followed by internal structure and finally employee competence category.

4.2 Items Of Reporting

Under the component of external structure, out of total 13 items, the disclosure of the years of relationship between a company with its major customers, is regarded as the highest reporting item. Under the component of internal structure, most companies discussed about their effort towards quality performance, such as conformance with international quality standards (ISO), out of total 28 items. Whereas, under the component of employee competence, the discussion is mainly on the importance of key personnel towards the company's success, out of total 22 items. The management acknowledges their dependence on the key personnel in achieving the company's vision and mission.

4.3 Trend Of Icd

There has been no significant difference in the amount of reporting, by category and total, between year 2005 and 2006 of IPO prospectuses. This result tally with the trend reporting of USA from 1993-1997 (Abdolmohammadi, 2005). However, reporting in Sri Lanka (Abeysekera and Guthrie, 2003) from 1998-2000 and Italy (Cordazzo, 2007) from 1999-2002, shows increasing trend. As such, there has been some level of growing awareness of importance in the ICD in foreign countries, as compared to Malaysia.

5. Conclusion

This exploratory study on the extent and trend of reporting of ICD in the Malaysian primary market has illustrated a situation of minimal ICD over the periods for companies seeking for listing in the stock exchange. Even though, there has been a lot of argument for the importance of ICD, but there is still a lack of growing awareness among the Malaysian corporate on its importance. As such, it is necessary to regulate the reporting of ICD, at least to some extent, so that users of an organization can use the information to make informed decision and safeguard their net worth.

In the future, research could be conducted to investigate the extent of ICD in 2007, to compare with ICD of 2006, as a method to investigate for the level of growing awareness of ICD reporting between these two periods. As the world is getting more complex over the years, acknowledgement and disclosure of IC, may enable a corporation become more competitive and beneficial in the long run.

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APPENDIX I

IC Disclosure Framework (Adopted from Bukh et al, 2005)

Item	Ref	Measurement/Indicator
	E	EMPLOYEES
1	E1	Staff breakdown by age
2	E3	Staff breakdown by gender
3	E7	Staff breakdown by level of education
4	E8	Rate of staff turnover
5	E9	Comments in changes in number of employees
6	E10	Staff health and safety
7	E11	Absence
8	E12	Staff interview
9	E13	Statement of policy on competence development
10	E14	Description of competence development program and activities
11	E15	Education and training expenses
12	E16	Education and training expenses/number of employees
13	E17	Employee expenses/number of employees
14	E18	Recruitment policies
15	E19	HRM department or function
16	E20	Job rotation opportunities
17	E21	Career opportunities
18	E22	Remuneration and incentive system
19	E24	Insurance policies
20	E25	Statement of dependence on key personnel
21	E26	Revenues/employee
22	E27	Value added/employee

	C	CUSTOMERS
23	C1	Number of customers
24	C2	Sales breakdown by customers
25	C3	Annual sales per segment or product
26	C4	Average customer size
27	C6	Description of customer involvement
28	C7	Description of customer relations
29	C8	Education/training of customers
30	C9	Customers/employees
31	C10	Value added per customer or segment
32	C11	Market share
33	C12	Relative market share
34	C13	Market share, breakdown by country/segment/product
35	C14	Repurchase
	IT	INFORMATION TECHNOLOGY(IT)
36	IT1	Description and reason for investments in IT
37	IT2	IT Systems
38	IT3	Software assets
39	IT4	Description of IT facilities
40	IT5	IT expenses
	P	PROCESSES
41	P1	Information and communication within the company
42	P2	Efforts related to the working environment
43	P3	Working from home
44	P4	Internal sharing of knowledge & information
45	P5	External sharing of knowledge & information
46	P6	Measure of internal or external failures
47	P7	Fringe benefits & company social programs
	RD	RESEARCH & DEVELOPMENT (R&D)
48	RD4	R&D invested in basic research
49	RD5	R&D invested in product design/development
50	RD6	Future prospects regarding R&D
51	RD9	Patents pending
	SS	STRATEGIC STATEMENTS
52	SS1	Description of new production technology
53	SS2	Statements of corporate quality performance
54	SS3	Strategic alliances
55	SS4	Objectives and reasons for strategic alliances
56	SS5	Comments on the effects of the strategic alliances
57	SS6	Description of the network of suppliers and distributors

58	SS7	Statements of image and brand
59	SS8	Corporate culture statements
60	SS9	Best practice
61	SS10	Organizational structure
62	SS14	Information of corporate social responsibility and objectives
63	SS15	Description of employee contracts/contractual issues