

Viewpoint

Intellectual capital disclosure and non-financial reporting – current issues related to policymaking

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Abstract: Challenges related to intellectual capital and non-financial reporting have occupied the accounting profession for a long time. Intangible resources, which are of great importance in knowledge economy, can only meet the criteria for validation in traditional financial reports to a limited extent. As a result, entities often choose the voluntary disclosure approach to communicate about these topics with stakeholders. Nowadays, sustainability-related information in non-financial reports is a crucial part of the dialogue between companies and stakeholders. In the future, when disclosure standards related to sustainability and intellectual capital are in force, the attention and focus may shift to the quality of information that is provided. Although entities will probably comply with standards, the depth of their communication will make a difference to stakeholders. The purpose of this viewpoint paper is to provide an overview of the difficulties associated with intangible capital reporting and non-financial reporting, and to support the preparation for challenges related to standard-setting by way of highlighting practical and academic implications.

Keywords: intellectual capital; non-financial reporting; disclosure standards; sustainability

1. Introduction

The value relevance of financial statements has been questioned for a long time due to lacking elements that are part of the so-called intellectual capital (IC) of entities. The latter is traditionally classified into the sub-categories of internal (structural), external (relationship), and human capital (Sveiby, 2001). The primary external users of financial reports run their analyses and make their decisions about financing entities while lacking essential data about the intangible resources employed by companies. Internal stakeholders also require such data to support and underpin the strategies they prepare. Accordingly, there is a need for information on intellectual capital both inside and outside firms. This need evokes reporting challenges because of the special features of intangible assets (IA).

Accounting records are based on the prevailing reporting paradigm, according to which a set of recognition criteria defines the content of financial statements. However, the control and potential economic benefits of the latter are not evident for many intangibles, which makes it challenging to list them on balance sheets. Of course, since laws and standards provide only the framework for the preparers of reports, the creation of firm-specific accounting policies and voluntary disclosure practices provide further space for communicating with stakeholders.

Another controversial area related to corporate reporting is non-financial reporting. These kinds of disclosures are often called environmental, social, and governance ones (ESG) (Mion & Loza Adauí, 2019). Also, the following expressions are used by scientific literature: sustainability reporting (Berthelot et al., 2012), integrated reporting (Mervelskemper & Streit, 2017), and corporate environmental sustainability reporting (Ortas et al., 2015). We consider these terms closely related and rooted in the fact that only providing financial information is no longer satisfactory for stakeholders. The purpose of this paper is to provide an overview of the difficulties associated with intangible capital reporting and non-financial reporting, and to support the preparation for challenges related to standard-setting as non-financial reporting has become mandatory for certain entities in the European Union. The structure of the paper is as follows: the next chapter covers the link between non-financial reporting and economic

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theories and the regulation behind intangible reporting. The study continues with describing the dissatisfaction with financial information in corporate statements and offers some findings of previous research on integrated and non-financial disclosure. The following chapter explains the views of international organizations that have been working on this issue for over twenty years now. The next section outlines the current regulatory steps taken by the European Union and, at the end of the paper, concluding remarks cover practical and academic implications.

2. Regulation and previous research on intangible reporting

Non-financial reporting has been associated with legitimacy theory (Manes-Rossi et al., 2018; Ortas et al., 2015), but corporate disclosure has been linked to several other theories as well, e.g., stakeholder theory, signal theory and agency theory (Lakatos, 2013; Shehata, 2014). Organizational legitimacy theory suggests that an organization can only operate within a framework set by members of a society (Pereira Eugénio et al., 2013). Therefore, the theories suggest that managers should communicate information that influences users' perceptions of their organizations (Cormier & Gordon, 2001; Deegan, 2002).

Reporting information on intangible assets by integrating them into the numerical sections of financial reports is not always possible. According to the current recognition criteria defined by the International Financial Reporting Standards (IFRS), namely, in document IAS 38 (included in Commission Regulation 1126/2008), many such resources will remain out of scope for reporting in balance sheets. In the case of separately acquired intangibles, valuations can be made based on measurements associated with the related business transaction(s): separate acquisition; acquisition as part of mergers; a government grant; or exchange of other assets. Consequently, recognizing such items causes fewer complications. However, internally generated goodwill – as specified in Paragraph 48 – shall not be recognized as an asset. Standard-setters even mention the fact that the difference between the market value of entities and the carrying amount of their net assets can be explained by various factors but is not directly attributable to the cost of intangibles *controlled* by the entities. However, this book-to-market value gap has inspired a great amount of scientific literature and has been connected to the issue of intangibles by professionals (Lev, 2003; Brand Finance, 2018).

Lev (2018) found that widespread dissatisfaction with financial information remains despite standard-setters' efforts to improve the usefulness of financial reporting. According to the author, the consequences are serious and may lead to uninformative balance sheets (ibid. p. 466). Glova et al. (2018) examined data from 313 publicly-traded European firms and, covering the period 2014-2017, found that R&D expenditure has a positive impact on firm value. The strategy of acquiring intangibles from external sources did not have the same effect for the sample firms: the results showed that the increasing value of such assets may have a negative impact on market value (Glova et al., 2018, p. 90). This implies that capitalized intangible assets may not be the ones driving market value and the disclosure on internally developed items seems more value relevant when it comes to convincing market participants.

Integrated reporting motivated the research of Corbella et al. (2019), who explored the relationship between intellectual capital and the process of preparing integrated reports. The authors identified the purpose of integrated reporting as to how an organization informs capital providers about how value is created in the short, medium, and long terms. The results of the interviews in the study suggest that the definition, classification, and valuation of IC involves an ongoing interaction between several actors, even extending to those who are not directly involved in the process. In the following section, we are describing the approach taken by two prominent organizations that published their ideas almost a decade apart and we are comparing the recommended measures.

3. Policymakers' view

Over the past decades, many prominent organizations addressed the issue of intellectual capital reporting. The Organisation for Economic Co-operation and Development

issued a report twenty years ago (OECD, 2012) and claimed that accounting difficulties related to intangible assets had been noted as early as the 1990s. The elaboration of different frameworks had primarily been led by the private sector and academia – a collection of 40 methods is included in the annex of the document based on Sveiby (2010).

One of the issues tackled by the OECD report (2012) is policymaking related to intellectual capital reporting. The overall picture was that the adoption of reporting procedures on a global level failed to reflect reality, and had many hindering factors such as the lack of standardization, the perceived risks and costs of enhanced disclosure, and the industry – or even company – specific nature of IA. With these difficulties in mind, the report states that policymakers typically leave this area – already dominated by the private sector and professional bodies – to investor demand and market dynamics. The OECD's final key message for policy makers is to engage in global coordination to address IC reporting, even if the idea of a globally harmonized disclosure framework is a distant goal.

Almost a decade after the publication of the report mentioned above, the European Financial Reporting Advisory Group (EFRAG, 2021) issued a discussion paper (DP) on how to provide better information on intangibles to interested parties. The DP states that even after decades of discussion, there are many dissenting opinions about how to solve this problem – and there are combinations of solutions. The scope of the paper is limited to addressing information that is provided to the primary users of financial reports included in primary financial statements, notes, and management reports. However, it is emphasized that important changes are ongoing in the field of sustainability reporting. And, ultimately, it is stated that sustainability reporting and financial reporting are closely linked, as non-financial data may be considered 'pre-financial' data (assuming that in the future, such data will impact the performance of a company). The DP's arguments are strongly based on the idea of stewardship, as the ultimate goal of financial reporting is to support users to make their own estimations of future prospects *and* to formulate their views about the accountability of management.

EFRAG earlier advocated the concept of stewardship during the course of the reform of the Conceptual Framework for the IFRS standards (EFRAG et al., 2013). Before the existing Framework was published, standard-setters had done substantial work to modernize the earlier version. After consideration of alternative versions, it was decided not to include stewardship *as a separate objective* of financial reporting. However, according to the 'European view' represented by the EFRAG, financial reports should provide information that is helpful for assessing whether an entity has been managed in the interests of its shareholders; and this is applicable to the assessment of the management's accountability or stewardship.

Table 1. EFRAG's potential solutions to problems with IA disclosure.
Source: Own edition based on EFRAG (2021), p. 7.

Major approaches described in EFRAG's DP		
Recognition and measurement of IA in <i>financial statements</i>	Information on <i>specific</i> IAS in notes or the management report	Information on <i>future-oriented</i> expenses and risk/opportunity factors in notes/management report
Examples: type(s) of intangibles, standardized metrics, related KPIs, economic life, need for maintenance or replacement (p. 40-43.)		

One can argue that it would not be possible to provide all the necessary details for assessing stewardship without adding relevant information on intangible capital. The approach taken by EFRAG is embodied in the three main approaches described by the DP (Table 1): these are evaluated based on insight into the reactions of some representatives of the community. The conclusion is that most variation is related to the first approach: the

recognition and measurement of IA in financial statements. Not surprisingly, the question of altering the recognition criteria to include more intangibles would be controversial, as it would involve selecting appropriate valuation methods for these types of resources. Both the cost model and the fair value model could be questioned for the valuation of intangibles because the former may not provide relevant information to the users of financial statements and the latter would be complicated as these items are mostly not traded on active markets and they are specific to the entities that create them.

The advantage of providing information on *specific IA* in disclosures, according to EFRAG's DP, is that it can supplement information on recognized intangibles but is less costly, less complex, and less subjective compared to recognition in balance sheets. This suggestion is grounded in the fact that many entities (especially in intangible-intensive sectors) already use voluntary disclosure channels (although not all of them), and the information that is provided is not comparable since there is no uniform framework for this. Through the introduction of new requirements, users would receive better and comparable information from all preparers and would have a better understanding of how the value-creation process is built on IA.

The third approach drafted in the DP (EFRAG, 2021, p. 52) is publishing information on *future-oriented* expenses as well as risk or opportunity factors in the notes or management report. This is a more indirect approach since it does not include the description of specific items but deals with those expenses which can be matched with future benefits and it likewise does not deal with the risks and opportunities embedded in IC in general. Information on the use of unrecognized IA is essential for assessing an entity's future cash flows because some of these items are maintained over the course of the business (e.g. customer lists), some of them become more valuable as they are used (e.g. social media platforms) and some of them need to be replaced eventually, which results in further expenditure (e.g. the outcome of a marketing campaign) (EFRAG, 2021, p. 56). EFRAG's view is that the ways businesses deal with risks and opportunities can also provide input for evaluating some aspects of the stewardship of management.

It is apparent from the approaches described above that one way to move forward would be to mandate additional disclosure related to IA. If policymakers were to define additional disclosure requirements, many of the problems would be similar to those in the field of sustainability reporting. Hopefully, the creation of corporate sustainability disclosure standards can stimulate intellectual capital reporting as well, and the synergies between these two controversial areas can be utilized by policymakers and academics.

4. Non-financial reporting and policymakers

The areas of sustainability and intangible disclosure are closely connected under the broad topic of corporate reporting (Zambon et al., 2020). According to Tarquinio and Posadas (2020), the meaning of 'non-financial information' is still unclear: in the latter's literature review, twenty-eight different definitions were identified from sources published between 1990 and 2018. The authors mention intellectual capital disclosure as one of the seven categories of non-financial information, which ranks the second highest in importance in the definitions after corporate social responsibility (Tarquinio & Posadas, 2020, p. 738). Environmental, social responsibility and governance-related items were essential parts of the intangible disclosure elements identified by Ragini (2012), whose work can be considered one of the most extensive content-analysis research tools in the literature, with a disclosure index consisting of 180 items that include IC and environmental, social and governance data. Stolowy and Paugam (2018, p. 540) also reveal the remarkable overlap between the content of non-financial disclosures and intangible elements, such as human resources, strategy, and value creation. According to Badia et al. (2019), integrated reporting can play a distinct role in mobilizing intellectual capital elements.

Companies communicate their contribution to sustainability to their stakeholders in the form of non-financial reports (e.g., integrated reports, sustainability reports, CSR reports, ESG reports, etc.) (Győri et al., 2021). Stakeholders value this information, and many directly seek the investment opportunities that ESG funds offer (Garamvölgyi, 2021). Today, however, not only do the information needs of stakeholders affect the NF disclosure practices of companies but so do different regulations. Directive 2014/95/EU (NFRD) orders public interest entities

(PIEs) to publish non-financial reports (starting from 2017) on environmental, social, and ethical factors and impacts. This was followed by EU Regulation 2019/2088 (SFRD) on sustainability disclosures in the financial services sector, which details the non-financial reporting obligations of financial service providers to disclose their sustainability risks and decisions concerning their investment products. The next step was a proposal published on 21 April 2021 (COM/2021/189 final) to introduce a Corporate Sustainability Reporting Directive (CSRD). With this reform, the EU plans to finalize non-financial reporting obligations from the financial year 2023 onwards. The personal scope of the NFRD currently in force will be extended to all listed companies (except for micro-entities) and all large companies. A mandatory audit of sustainability information will also be required, and reports should be published according to the sustainability reporting standard published by the EU. Moreover, reports must be published as part of the management report and should be in a digital format that is machine-readable.

The two phenomena most often highlighted by critics of the credibility of non-financial reports are greenwashing and cherry-picking. Greenwashing means that despite the polluting effects of a company's activities, companies present a more positive image of themselves in reports than in reality. In the case of cherry-picking, companies are allowed to publish only information and indicators that show a positive picture due to the shortcomings in regulating the form and content of non-financial reports. Newly proposed EU legislation seeks to address both of these concerns.

In our opinion, similar problems arise with IC reporting. First, the goal is to somehow incorporate items into the disclosure of companies that do not correspond to traditional accounting recognition criteria but are of interest to stakeholders. Second, voluntary reporting frameworks already exist in practice, fostered by prominent professional organizations. Third, policymakers have realized the need for standardization and are taking cautious steps toward the development of mandatory frameworks.

5. Conclusion and implications

From an academic perspective, it is noteworthy that the EU has moved away from using the term 'non-financial' towards the notion of sustainability in corporate disclosure. Future research should concentrate on the width and depth of the specified information. By this, we mean that it is possible to analyze which topics are covered (width) and in what detail companies report on given topics (depth), as both dimensions affect the quality of the information provided to stakeholders.

In the future, when ESG and IC-related disclosure standards come into force, the attention and focus may shift to the quality of information that is provided. Concerning practical implications, as entities are likely to comply with future standards, it will be the depth of communication that will make a difference to stakeholders. Those firms that will make an effort and will go beyond checking the boxes on a list of mandatory disclosures and will remain determined to disclose high-quality information will stand out as best practice.

The accuracy of information will be another issue that many market participants will respond to. The assurance of non-financial reports is another developing field that will play a key role in ensuring the integrity of disclosures provided to users and will ultimately contribute to the optimal allocation of capital that sustains the goal of long-term value creation.

In the meantime, policymakers and academics should seek to promote the synergies that arise from similarities by addressing the challenges associated with these two areas. To promote best practice in corporate reporting it is necessary to support the education and training of current and future professionals who will engage in the nuances of corporate reporting for decades to come.

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