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12. Financial reporting in the new economy

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The fundamental objective of preparing financial reports is providing financial information for the users of reports, primarily to investors and creditors who use that information when making their decisions about allocating their resources. Living in the so-called new economy, it seems obvious to expect that information regarding knowledge assets will be found in these reports. However, actual financial reporting standards do not support the recognition of internally generated intangible items on the balance sheet. Voluntary disclosures are a possible alternative for firms who are willing to give information on their intangible resources to the stakeholders. The inflexibility of the regulations lead companies to developing intangible reporting practices that sometimes exceed the scope of financial reporting. Nevertheless, financial reporting is the only form of providing information that is based on the same standards and conceptual basis, making users able to compare data of different preparers.

The underlying research questions are: how the existing intangible accounting rules are applied in business reporting practice and which are the related features of the financial reporting culture in Hungary. As financial reporting regulations and literature associated with the topic has been investigated, the planned empirical research includes the collection of both quantitative and qualitative data. Based on the empirical findings of several international surveys, a similar research on a Hungarian sample will be executed using the data in the financial reports of entities. The objective is to measure the amount and quality of the information preparers disclose on intangible resources and to find association with some corporate-specific features (e.g. size, sector, book to market ratio, capital structure etc.). Examining the intangible reporting practices of larger companies also can serve as an input in the other line of the planned research, which involves collecting quantitative data regarding the intangible reporting culture of Hungarian firms. The expected outcome is the drawing of some proposals for the improvement of the intangible reporting culture of the smaller firms of the region.

Key words: financial reporting, intangible resources, knowledge assets, voluntary disclosure

1. Introduction

In theory, financial reports are designed to cover all information that users of reports need to make their financial decisions. According to the International Accounting Standards Board (IASB) which is the leading international standard setting body, the objective of financial reporting is to provide financial information that is useful to investors and creditors in making their decisions about allocating their resources. That information includes data on the financial position, performance and cash flows of the entities, among which assets or resources of the companies are fundamental. The new economy – as we often call it – has brought intangible resources to the center of attention as they appear to be key factors of competition. However, the most widely used international financial reporting system, the IFRS defines recognition criteria that lead to a very limited set of intangible assets presented on the balance sheet. The reason for this is that intangible resources have some specific features that are very difficult to harmonize with the present framework of financial reporting regulations. This situation is apparent in different regulation environments, in international standards as well as in most country-specific regulations.

Companies' reactions to the difficulties related to intangible reporting are diverse depending on features like size, sector, profile, capital structure, etc. Large international firms often have significant intangible resources and are able to cover the cost of reporting such information, even in the form of voluntary disclosures. New reporting systems have evolved in the last decades to amend traditional financial information regarding topics of social responsibility, environmental issues, sustainability, value creation, etc. These voluntary disclosures or reports show an expedient, yet expensive example of putting intangibles in the spotlight. Yet, the ratio of these powerful companies among all participants of the markets is relatively low in many countries. Smaller or even say micro-size companies have fewer resources to allocate to creating annual reports. That does not imply that they do not have any intangibles to show. Is reporting intangibles only the game of big firms?

2. Intangible resources and financial reporting

The obvious way of reporting information on intangible assets is integrating them into financial reports. However, present financial accounting regulations seem to provide narrow space for intangibles on balance sheets. International Financial Reporting Standards (IFRS) issued by the IASB are applied in over one hundred countries including the member states of the EU. IFRS standards define recognition criteria that lead to a very limited set of intangible assets presented in financial reports. The definition of an asset derives from The Conceptual Framework for Financial Reporting, which defines the basic concepts of reporting (IFRS Foundation 2010, par. 4.4.): '*An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity*'.

The definition of intangible assets is included in International Accounting Standard 38 Intangible Assets (IFRS Foundation 2012, par. 8.): *'An intangible asset is an identifiable non-monetary asset without physical substance'*.

The recognition criteria set by the Framework are the rules that specify which items are incorporated into financial reports, which involves the depiction of the item in words and by monetary amounts. Items that satisfy the recognition criteria are presented on the balance sheet or the income statement. According to the Framework the recognition criteria are the following (IFRS Foundation 2010, par. 4.38.): *'An item that meets the definition of an element should be recognised if:*

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured with reliability'.

Very few *internally generated intangible items* meet the recognition criteria because the economic benefits they incorporate are associated with high risk (i.e. the case of research costs) and measuring their value is a great challenge. Furthermore, they hardly correspond to the existing definitions, because intangible resources like competence experience and ideas of the workforce or technological expertise are not assets *controlled* by the companies. Basically, the only type of internally-generated intangible resources that appear on the balance sheet are development costs and know-how (protected by contract). Intangible assets that are of external origin (purchased, acquired as part of a business combination or by way of government grant) are much easier to place in financial reports as they are traded on the market, which makes them easy to identify, control and measure (i.e. brands, patents, trademarks, customer lists). However, the Framework for IFRS requires entities to enclose information on all items that are essentially assets but fail to meet the recognition criteria in case knowledge of the item is relevant to the evaluation of the financial position. Upton seizes the heart of the problem stating (Upton 2001, p. 70.): *'Is there any rationale based on the definition of an asset, why those items are assets when acquired in a business combination or other purchase and not assets when created internally? No. Genealogy is not an essential characteristic of an asset'*

As a consequence of the above described regulations, IFRS financial reports basically exclude internally generated intangible items or knowledge assets from the balance sheet. The structure and approach of *Hungarian accounting regulations* is different from that of the IFRS standards but the final results are very similar. Our Accounting Act gives a list of the items that shall be presented on the balance sheet in a specific format. The definitions given in the intangible section of the balance sheet are also tailored for acquired items. However, besides development cost, by

Hungarian rules, the cost of incorporation (start-up costs) and reorganization are also allowed to be capitalized in case the expected economic benefits exceed their cost. Hungarian regulations require entities to describe research and development activities in the company report, which supplements the data given in the financial report. Similarly to IFRS, the Accounting act also prescribes preparers to enclose information on off-balance sheet items that incorporate significant benefits or risk that influences the financial position of the entities.

Taking *small and medium size companies* into consideration, the international reporting standard setters have published a separate standard called IFRS for SMEs in 2009.[1] IFRS for SMEs includes similar definition and recognition criteria for intangible assets but expressly prohibits the recognition of internally generated intangible items. Hungarian accounting rules identify a separate types of financial reports for SMEs and micro-size entities. Small and medium size enterprises may opt to prepare reports under some simplifying rules and as a consequence have to include in the balance sheet only the overall amount of intangible assets and no compulsory disclosure on off-balance sheet items or research and development is required. However, they are allowed to supplement the financial information given is the balance sheet. *Micro-size companies* are allowed to prepare reports with even more reduced data, but any notes to the balance sheet are excluded in this type of report.

Basically we have a reporting framework (both on country and international level) that cuts off most internally generated intangible assets from the balance sheet and we do have a business environment that is considered to be built on knowledge. This seems to be a great contradiction. Lev (2003) summarizes the consequences of the mismeasurement or deficient reporting of intangibles:

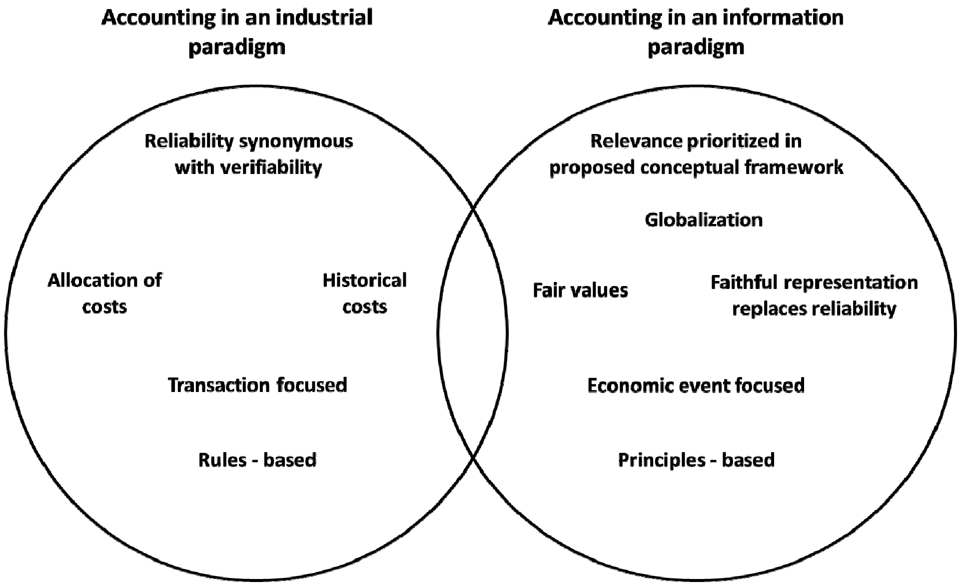
1. significant deterioration in the information content of key financial statement items;
2. managers looking for alternate measures of corporate performance for internal purposes;
3. systematic undervaluation of companies that are intensive in intangibles (excessive cost of capital);
4. gains are missallocated to insiders because of the great information asymmetry.

The standard setting bodies, the International Accounting Standards Board or the Hungarian legislative bodies face a great challenge if they intend to react on the critique that has been drawn lately. Studies about a possible paradigm-shift in finan-

[1] International Accounting Standards Board (2009): IFRS for SMEs is applied on a voluntary basis by entities, it is not mandatory for any conpanies in the EU.

cial accounting have been published ever since the 1970's (i.e. Wells 1976, Elliot 1992). Opinions given by accounting professionals show great differences, but the fact is financial reporting paradigm is presently undergoing some changes. Shortridge–Smith (2009) predict the specific characteristics of the new accounting paradigm which are: relevance, globalization, fair values, faithful representation and principles-based regulation (Figure 1).

Figure 1. Financial reporting paradigm shift



Source: Shortridge–Smith (2009, p. 12.)

Upton gives an extensive review on intangible reporting regarding the background, the basic definitions and the topics of the evolving new reporting paradigm, new metrics and intangible asset accounting. The author also highlights the focus to concentrate on (Upton 2001, p. 9.):*'We may have a new economy, or our new tools may have given us an appreciation of factors that were always important. It doesn't much matter which. The more important question is how to improve business and financial reporting'.*

In the following section some research studies will be introduced which all aim to find association between the level of disclosure of intangible items in financial reports of the sample companies and some country-specific or firm-related factors. These studies are all based on samples containing large firms, from different countries and industry sectors. The data is collected by analyzing the intangible-related information disclosed by firms, usually in the narrative sections of the financial reports. In all cases some kind of self-constructed disclosure index is applied.

3. Preparers' point of view – international studies

Considering preparers and users financial reports, they have to align with existing regulations. As we have mentioned, the reporting framework includes some alternative choices for the entities therefore the application of the rules and the methodology of reporting might show some differences between companies. Those companies that have significant internally generated intangible property make their decisions about consigning such information to the stakeholders. As we have seen, financial reporting regulations do not support including these types of assets on the balance sheet. However, preparers have an alternative opportunity to supplement the data given in the financial reports: they can prepare any kind of business reports on voluntary basis. Totally new frameworks of business reporting have evolved over the last decade and some companies devote significant resources to disclose information on sustainable growth, corporate responsibility, human capital etc.

Annual reports created by firms that operate in different countries show the diversity of the reporting culture related to intangible property. Several international studies have been organized to find relationship between the amount of intangible items reported in mandatory or voluntary disclosures and other features of companies.

Ragini (2012) examines and compares various disclosure practices of the top one hundred Indian, US and Japanese firms over the period 2000-2005. The sample includes the first 100 most valuable companies of India in the Compedium of Top 500 Companies in India, 100 US, and 60 Japanese companies listed in the Fortune Global 500 World's Largest Corporations. The author creates a disclosure index of 180 intangible items classified into the following groups: research and development, strategy and competition, market and consumer, human resource, intellectual property rights & goodwill, corporate and shareholder information, environment and others. The study reveals that all countries show a significant improvement in their overall disclosure scores over the five year period. The author also analyzes group-wise disclosure and finds that Indian companies disclosed more information on 'research & development' and 'human resource' while US companies disclosed more information on 'strategy and competition', 'market and consumer', and 'IPRs and goodwill'. Japanese companies disclosed more on 'corporate and shareholder' and 'environment and others' (Ragini 2012, p. 57.). The study also discusses the association between selected company attributes and overall disclosure scores. The results show that the disclosure score of the Indian entities are more associated with organizational size and profitability, while those of the US companies are more associated with industry type. In case of the Japanese companies, disclosure scores are associated with organizational size (Ragini 2012, p. 61.).

Kang and Gray (2009) examine the extent of intangible asset disclosure of emerging market companies. The source of their sample is the list of the top 200 emerging market companies in 2002 from the July 14, 2003 issue of Business Week. The authors analyze the narrative sections within the annual reports of the final sample of 144 firms. The dependent variable in the calculation is the level of intangible asset disclosure based on an index measured using the Value Chain Scoreboard elaborated by Professor Lev Baruch. The independent variables are different corporate and country specific features. The results of the study show that corporate-specific factors, such as the adoption of global (international) reporting systems (IFRS or USGAAP[2]), industry type, price-to-book ratio are the key factors significantly associated with intangible assets disclosure. Country-specific factors including risks associated with economic policies and the legal systems are also found to be of key importance (Kang–Gray 2009, p. 420.).

Kumar (2013) performs similar calculations on a sample of all U.S.-listed Asian companies in the year of 2007, totaling 74 firms from nine countries in the final sample. The results indicate that larger firms, firms with greater ownership dispersion, and firms with lower leverage provide more voluntary disclosure of intangibles information. Kumar also examines the effect of domestic culture on the level of disclosure incorporating two of Hofstede's cultural dimensions into the model. Results show that sample companies from countries that are more individualistic are providing higher voluntary intangible information (results failed to support the hypothesis related to power distance).

4. Planned research

The reason why international studies of intangible reporting focus on large firms is obvious: they are the ones that have the resources and are capable of preparing such reports. Part of the planned research is accomplishing similar analysis to those described in the previous section. An analysis on a Hungarian sample is planned using

[2] United States Generally Accepted Accounting Principles.

the same intangible disclosure index as Ragini (2012). Additional data on corporate-specific features (applied standards, size, sector, capital structure, market to book ratio etc.) of the firms will also be obtained from the financial reports disclosed by companies. The purpose of the work is discovering the tendencies of the largest Hungarian firms: identifying the groups of intangible items they are reporting. The data gained from the research could also help identifying some areas to improve and showing the best practice of intangible reporting among large firms.

The most numerous group of companies, the small and medium size entities are also possible subjects of research. Counting the intangible items is their financial reports would probably lead to less impressive results than the previously mentioned researches, but there lie some answers to be found considering SMEs too. A firm being small does not mean that it possesses no significant intangible property to report to stakeholders. In today's knowledge based economy start up activities are based on new technologies, ideas, implemented by qualified workforce, all of which are intangible resources. Many companies start small and perform phenomenal growth paces, which is impossible without investors or creditors who buy into the ideas they are selling. Investors and creditors are the primary users of financial reports, therefore these reports should serve as a tool of disclosing all the information they need. Does it really work that way?

The aim of the future research is to discover the financial reporting culture of the SMEs of the region. In order to gain some information besides the data of the financial reports, some qualitative research is planned. Questionnaires and interviews are appropriate research methods to answer the questions related to the following research topics:

- firms' opinion on the purpose of financial reporting;
- the usefulness of the narrative sections of financial reports;
- voluntary disclosures in annual reports;
- the relevance of the deficiencies of intangible reporting standards/regulations;
- identifying, registering and measuring intangible property.

The expected outcome of the planned research is creating a database on the intangible items reported by large Hungarian firms. The database could be used to execute some statistic calculations based on which comparisons are possible with the results of the mentioned international surveys. Examining the intangible reporting practice of larger companies also can serve as an input in the process of creating the questionnaire and interview questions for the survey related to smaller entities of the region. Those practices applied by domestic enterprises are easier to understand and embrace for smaller preparers, therefore these examples may facilitate the drawing of some proposals for the improvement of the intangible reporting culture of the smaller firms of the region.

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