Understanding Intellectual Capital from annual reports: emerging challenges

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The aim of this paper is to analyse if, how and to what extent IC can be reported within annual reports according to the national and international accounting standards.
Intangibles and IC

IC ≠ intangibles ≠ intangible assets

- **Intellectual Capital**
  - Human Capital
    - Competences
      - Know how
      - Knowledge
    - ... (Knowledge management)
  - Structural Capital
    - Information systems
      - Databases
      - Patents
    - ... (Database management)
  - Relational Capital
    - Customer capital
      - Relationships
      - Brand
      - Image
      - Reputation
    - ... (Customer relationship management)

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The IC issue includes both accountants and non-accountants (Johanson and Henningsson, 2007).

Increasing relevance of IC disclosure (Kaufmann and Schneider, 2004).

Grew in importance from the late 1980s. In some cases 90%+ of market value or purchase price (Lev, 2003; Brannstrom et al. 2009).

How to account for the “hidden value”? How to make the invisible visible? The iceberg metaphor...
IC and annual reports

Two main approaches to «construct and measure» IC in annual reports:

- Quantitative (the idea of FAIC) (e.g. Brännström, et al., 2009; Brännström and Giuliani, 2009; Brennan, 2001; Roslender and Fincham, 2001; Seetharaman, et al., 2004).

- Qualitative (Bozzolan, et al., 2006; Guthrie and Petty, 2000).

The construction and the “size” of IC change in dependence of the adopted GAAP…
The main issues:

- Identification of most of the “typical” IC components.
- A mandatory classification model is provided but with a residual class (not a “good” model).
- Cost capitalization is allowed.
- Goodwill only if purchased (not internally generated) and assumed as a residuum.
- Cost-based valuation (value in use as a benchmark).
- Amortization vs. impairment.
Main critical aspects:

- **Risks** related to the item “altre immobilizzazioni immateriali” and to standard categories.
- **Goodwill**: still a “black box”.
- Possibile “abuse” of the idea of internally developed intangibles.
- **Amortization**: the idea of «conventional life».
- **Impairment** and the concept of «maintenance».
- Data heavily influenced by the **corporate tax law**.
The main issues:

- Identification of most of the “typical” IC components (less than in OIC).
- An “embryo” of a classification model is provided but it is not mandatory.
- Cost capitalization is NOT allowed (except R&D).
- Goodwill only if purchased (not internally generated) and has to be «explained».
- Cost-based vs. fair value criteria.
- Amortization vs. impairment.
Main critical aspects:

- Plethora of labels and lack of a “good” classification model.
- Goodwill: still a black box? May be “grey”, but still a default.
- The internally developed intangibles’ problem.
- Too much freedom for the CFO in the recognition and valuation phases? It seems tight but something can sneak out…
• IC and OIC24 seem to be not fully compatible but «there is a light…». Few «classical» IC components (output) can be reported. HC is still hidden, RC is almost absent while SC partly emerges.

• If IC is an asset, what about Intellectual Liabilities? Wider and wider (Gowthorpe, 2009)?

• The problems of self-accounting (Roslender, 2009).

• Accounting for IC: harmonization vs. standardization (Brannstrom, Giuliani, 2009)?
Conclusions

• The production/consumption of information. The role of “external” actors (auditors, bank, tax office, shareholders, etc.).

• If financial statements have to be of help to investors, is it correct to not account for internally generated assets and goodwill even if they represent the largest part of a firm’s value?

• Information asymmetries and the existence of spaces for non mandatory information (at least in the OIC model).

• But….are firms really willing to disclose IC?
THANK YOU!

Questions, curiosities and suggestions are welcome