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Reporting on Intellectual Capital of a Company: Initiatives and New Reporting Model

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Abstract

One of the most urgent and still unsolved issues in the field of disclosure of information on the activity of a company is the valuation of intellectual capital (*further – IC*) and the presentation of the relevant information to the external stakeholders. A number of initiatives to perform this task have been observed in the whole world: work groups were created, standards were set and tried out in real life activity of companies of various profiles, on the grounds of the received feedback the suggestions were further developed and ultimately submitted for extensive application. That is why the current paper sets **the aim** of exploring worldwide initiatives of the standardization and regulation of the accounting and reporting of the IC so that to assess the prospects of the practical application of the developed models. The present research employed the common method of investigation based on analysis and synthesis of scholarly papers. Academic works and empirical researches in the fields of IC valuation, accounting and reporting were mostly used. Due to the novelty of the research topic and in order to achieve higher conciseness and visualization levels, information obtained from various articles and journals served as proof for practical valuations and observations. The paper explores various current IC reporting guidelines and frameworks, outlines their advantages and drawbacks and provides generalizations. Next, the paper foregrounds the need for reforms in the current reporting system and presents requirements imposed on this type of data disclosure. In conclusion, the paper gives a discussion of the direction of the potential reporting system reform so that the newly included IC-related information should be beneficial to various external stakeholders. As a result, two statements on IC for inclusion into annual financial reporting package are proposed: one of which is brief and concise, one to three pages long, whereas the second statement represents notes or a complementary report.

Keywords: Intellectual capital, reporting, initiatives, reform in reporting system, standardization

1. INTRODUCTION

Growing into the ‘knowledge economy’, IC gains relative importance. IC is defined as resources created in, purchased by or maintained by the company which has no tangible form and together with the tangible and financial capital of the company helps to create the added value. Innovation, access to cutting edge knowledge and information or educated workforce – to name only a few drivers – have turned out to have more influence for the long term success of a company than their financial and tangible assets. IC covers ultimately every one of those items necessary to a company’s daily operation in the ‘knowledge economy’ (European Commission, 2006). Therefore it is vital for senior managements to view IC in a strategic way if they wish to maximize the benefits that these assets can bring to their companies (Alcaniza, Gomez-Bezaresa & Roslenderb, 2011). Well managed IC is seen as a source of competitive advantage (Frederick, 2009), thus disclosing this type of

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information can sharpen the view on a company's creditworthiness (Mertins & Will, 2008). Nevertheless, IC remains difficult to reflect in 'traditional' financial statements (Frederick, 2009; Beattie & Thomson, 2010).

According to the current international accounting standards, only a minor part of IC is presented in financial statements. The 'traditional' financial accounting has been restricted to reporting on the value of an asset which is under control of a company based on past events and from which future economic benefits are expected to flow to the company. Therefore, since multiple aspects of IC are outside the control of the company, it becomes difficult for the 'traditional' financial accountant to report on some specific constituents of IC (Tongo, 2010).

There are dozens of private and some government-supported IC management and disclosure models with different conceptions of IC and desired reporting outcomes (Fijalkowska, 2008; Frederick, 2009; OECD, 2012). Although some guidelines do exist, they are generally adapted to local circumstances and business culture(s) and differ greatly from one to another in their terminology and methodology (European Commission, 2006). In addition, the variety of frameworks adds to the confusion for companies about the relative value of adopting one of these (OECD, 2012). This results in the noticeable variety of the number of indicators in the published intellectual capital statement (*further – ICS*); consequently, there is no final and universally accepted model (Bukh, Larsen & Mouritsen, 2001; Campos & Ordenez de Pablos, 2007; Abhayawansa, 2014).

Therefore, the purpose of this paper is to explore worldwide initiatives of the standardization and regulation of the accounting and reporting of the IC of a company. The paper explores various current IC reporting guidelines and frameworks, outlines their advantages and drawbacks and provides generalizations. Next, the paper foregrounds the need for reforms in the current reporting system and presents requirements imposed on this type of data disclosure. Finally, the paper gives a discussion of the direction of the potential reporting system reform so that the newly included IC-related information should be beneficial to various external stakeholders.

The paper is structured as follows. Section 2 explores various current IC reporting guidelines and frameworks, outlines their advantages and drawbacks and provides generalizations. Section 3 foregrounds the need for reforms in the current reporting system and presents requirements imposed on this type of data disclosure. Finally, Section 4 concludes the paper with a discussion of the direction of the potential reporting system reform so that the newly included IC-related information should be beneficial to various external stakeholders.

2. REVIEW OF THE NEW MODELS FOR IC REPORTING

In current research, it was established that methods of valuation of the IC suggested in scholarly papers are drafted at several levels. As shown in Table 1 (compiled by the author), level 1 methods only cover the methodology of valuation of the IC and its constituent parts. Level 2 methods involve not only aspects of the IC valuation but also those of its management (they may include internal reporting as well – for management purposes only) whereas level 3 models feature aspects of IC valuation, management and reporting. The focus of the present paper is specifically directed towards level 3 models.

Table 1. Levels of methods and models for IC valuation.

Level	
I	Methods of IC valuation
II	Models of IC valuation and management (may also include internal reporting)
III	Models of IC valuation, management and reporting (external and internal)

In order to make the selection of models for a more detailed analysis, the following criteria were established:

- 1) IC is mentioned in the description of the model and the issue of its reporting is dealt with. This criterion was selected because IC disclosure is often linked to corporate social responsibility and sustainability reporting (Frederick, 2009);
- 2) the model is either at the advanced level of development or the model has already been fully developed;
- 3) the concept of the model is universally accessible as this is not solely a publicly presented idea;
- 4) the concept of the model contains evident strife for universality, suggests guidelines or frameworks which are widely applicable and which are not specific initiatives developed by particular companies.

Having considered the above listed criteria and the conducted analysis of scholarly papers, even 21 initiatives striving to contribute to the issue of the IC reporting were discovered. Additionally, there are a number of individual initiatives which is not dealt with in the current study due to the limited availability of information. As the research results showed, at the moment various guidelines exist for the building of the ICS. Nevertheless, considerable confusion still exists in terms of the concepts used, the practices recommended and the final ICS

obtained (Palacios & Galvan, 2007). Upon having conducted a comparison of the new models for IC reporting analyzed in the current research, generalizations may be made that the first initiatives date back to 1994 while the peak activity was reached in the years 2000 to 2006. European organizations were the most active, they submitted 14 out of the 21 proposals dealt with in the present research. The initiators of these efforts were governments, European Commission, professional organizations, research centers and various committees. Of all the investigated IC reporting guidelines, only two have the status of Law acts and are mandatory, specifically, University Organization and Studies Act imposed on the universities of Austria and the Italian Public Administration Law. As for now, all the other guidelines are used as the voluntary standard of measurement and communication of their knowledge in hundreds and hundreds of companies (Fijalkowska, 2008). They do not represent norms that companies must follow as they are simple suggestions (Campos & Ordonez de Pablos, 2007). Voluntary reporting, however, implies a freedom to report but also the freedom 'how to report' (Alcaniza, Gomez-Bezaresa & Roslenderb, 2011). The current legislation presents the reporting entity with the possibility and not with a requirement of reporting, nor is it a requirement for a particular quality level to be achieved (Brannstrom, 2013). These statements are quite idiosyncratic and therefore incomparable (Campos & Ordonez de Pablos, 2007). Therefore, mandatory and globally accepted IC reporting standards would support reporting practices not only in terms of increased comparability but also in terms of reduction of selective disclosure and the risk of misleading information as well as creation of a common shared knowledge base about companies, their activities and their system of relationships (Perrini, 2006).

None of the investigated IC reporting guidelines presents a clearly defined and structured form for reporting. Instead of that, most of them show how to identify and measure the components of IC by using qualitative and quantitative indicators and give a rough draft how to communicate the results in an ICS (Pilkov, Papula, Volni & Hulvej, 2013). They all (Marr, 2008a): a) provide a breakdown and classification of IC, b) provide some guidance on the identification and measurement of IC, and c) outline a template or blueprint for reporting IC in ICS. Besides this, some of the initiatives provide advice on the ways of reading and analyzing ICS.

Many guidelines and frameworks are based on the inductive-analytical approach in an attempt to show the development of the full spectrum of IC by non-financial indicators such as customer satisfaction, training days per employee, IT infrastructure, etc. (Leitner, 2005; Riegler & Hollerschmid, 2006) with the purpose, primarily, of informing third parties about the value of this capital (Hervas-Oliver, Rojas, Martins & Cervello-Royo, 2011). However, there is minimal discussion of the corresponding intellectual liabilities: the poor product or service quality, inadequate or improperly focused R&D, poorly trained workers/management, inadequate new-product development processes, high turnover of employees, customers, or suppliers, discriminatory hiring practices; etc. Other examples include dangerous working conditions, potentially litigious products, product tampering by employees during labor difficulties, antiquated manufacturing processes, potential environmental cleanup and the poor company reputation (Tackett, Wolf & Kinsley, 2007).

Overall, many guidelines are not a full-fledged conceptual framework that can be used to develop reporting standards and guide IC reporting. However, the following key advantages of the already existing IC reporting guidelines and frameworks may be singled out in further discussions and researches in the field of IC reporting: 1) the new reporting model; 2) the need for policy intervention, particularly in the accounting standard setting process; 3) an additional report (ICS) to current 'traditional' financial statements; 4) a short, structured report; 5) orientation into ICS ability to be systematically read and analyzed in a way that is comparable with the reading and analysis of financial statements; 6) disclosures not only on intellectual assets, but also on intellectual liabilities; 7) target key performance indicators (*further referred to as KPIs*) and disclosures for current and past years; 8) KPIs grouping in several levels; 9) industry-focused reporting: various KPIs for certain industries; 10) the need for ICS audit.

3. THE REFORM IN REPORTING SYSTEM IS NEEDED

Both the companies and the capital market underline that it is necessary to take steps in order to improve the existing system of control and reporting (Fijalkowska, 2008; Tongo, 2010; Fadur, Ciotina & Mironiuc, 2011; OECD, 2012) by including more information on IC in a company's disclosures. Yet still there is much to be done and much work is required towards an international framework and a set of internationally harmonized guidelines for IC reporting (Chua, 2006; Campos & Ordonez de Pablos, 2007; Mertins & Will, 2007; Fijalkowska, 2008; Branwijck, 2012; OECD, 2012). However, when developing globally accepted IC reporting standards and outlining ICS it is essential to consider the needs of the external stakeholders. Presentation of information to stakeholders sets specific requirements (Van der Meer-Kooistra & Zijlstra, 2001; Marr, 2008b; Lakis, 2008): 1) stakeholders want to be able to compare data about different companies; 2) they expect the

presented information to be reliable, objective and containing protection from the involvement of subjective data; as a result, the quality of information must be possible to verify by independent auditors.

In order to make IC reporting of companies more relevant for external users, it is necessary to take into account the needs of financial analysts, investors and other stakeholders as well (Bukh & Johanson, 2003). Firstly, they need the disclosed information to be **comparable** between periods and/or between companies (Johanson, Koga, Skoog & Henningsson, 2006). Even though the value-creating sources and knowledge management are unique and specific in their nature depending on each company or context (Johanson, Koga, Skoog & Henningsson, 2006), standardization is more than necessary (Perrini, 2006; OECD, 2012). However, these are the most important challenges to the advancement of the IC disclosure agenda (OECD, 2012). As there is more to an ICS than just the numbers, its reading is different from the reading of a 'traditional' financial statement and there are no traditional ways to read and interpret it (Bukh & Johanson, 2003; Nielsen, Bukh, Mouritsen, Johansen & Gormsen, 2006; Riegler & Hollerschmid, 2006). On the other hand, another concern is that due to the variety of reporting frameworks, investors might not be able to use the reported information for comparisons between companies (OECD, 2012). That is why the disclosed information should have some degree of **continuity**. It means that many indicators should be repeated year after year; while in case of changes they should be explained in order to maintain credibility (Campos & Ordóñez de Pablos, 2007).

The second concern regarding the disclosed information on IC is its **content**. Users of ICS should be able to look at disclosed information and assess how well the company is fulfilling its objectives (Starovic & Marr, 2003). There is some consensus among investors on the need for the public disclosure of IC and the types of information desired such as the strategy, corporate governance, human capital and technology (Chua, 2006). Qualitative descriptions are considered equally important. Still more important are the indicators helping to quantify the information; especially the timeliness of indicators is a major requirement for ensuring quality of the information (Alwert, Bornemann & Will, 2009). Although, there is no predefined set of measures and the chosen set can include indicators measuring effects, activities or the resource mix (Starovic & Marr, 2003). Therefore, standardization and reliability are vital in developing KPIs that are useful for the financial community (OECD, 2012), e.g. number of apprentices and trainees, number / index of complaints, R&D expenditure etc.

Thirdly, it is important to consider that such external stakeholders as banks prefer a **clear and short** presentation including quantifications (Mertins, Wang & Will, 2009). Nevertheless, these statements are only successful if they are set in the context of the company's strategy, and if they go beyond the mere reporting of measures to include narrative and interpretive commentary (Marr, 2008a). Still, an ICS should preferably not exceed ten pages (Alwert, Bornemann & Will, 2009).

Furthermore, analysts appear to favor IC information that can be readily and easily **integrated** in their financial valuation models. It means that information on IC that cannot be easily incorporated into company valuations is less frequently referred to in analyst reports, even though they could be considered by analysts and other users of financial reporting as the useful background to the overall company strategy (OECD, 2012).

Finally, the auditing of IC information would make it more **credible and reliable** (Brennan & Connell, 2000; Mertins, Wang & Will, 2009). It would be the same as in 'traditional' accounting where independent auditors are assigned to verify the accuracy of financial statements. This process would help to authenticate or disapprove of the contents of ICS which are actually meant to facilitate the long term decisions that business stakeholders may be making (Tongo, 2010). However, assurance activities with respect to ICS still appear to be nascent, but this might be a new market segment (Chua, 2006).

To sum up, if these requirements on the comparability, content, length, integration possibilities and reliability of an ICS are fulfilled, this report consequently contributes to a more homogeneous rating of the company than any analyst-written assessment based solely on the information from annual financial statements (Mertins & Will, 2008). For this reason there is the desirability of having standards facilitating management, measurement and reporting on IC (Bukh & Johanson, 2003); this also improves the comparability, reliability and usefulness of IC related information to users (Frederick, 2009). However, the process of establishing what IC information should be disclosed, in what format and through what mix of channels is a complex issue (Beattie & Thomson, 2010). Therefore, government has a clear role to play in encouraging transparency and disclosure, and it is not at all certain that markets will automatically demand and generate greater transparency (Frederick, 2009). One specific area where policymakers could potentially have an impact is in engaging in global coordination to address this complex policy issue (OECD, 2012).

4. DISCUSSION

The absence of many IC from the balance sheet shows that current financial reporting practices are inappropriate and financial reporting certainly has limitations (ICAEW, 2009). It seems there is a challenge for accounting in dealing with the proper communication of company's IC, incurred investments on it, its role and value (Fijalkowska, 2008). Still, it would be naïve to assume that accounting standards are going to change radically (Gazdar, 2007; Frederick, 2009), as accounting needs continuity, and financial statements have to be comparable over long periods of time (Gazdar, 2007). Still, it does not mean that financial reporting cannot be improved.

Accountants already collect, analyze and report financial information and data, therefore they are best skilled to assist in ensuring internal controls are in place for collecting, compiling and reporting the appropriate data. These skills can be applied to reporting other information, such as IC (ICAA, 2008), and it seems that the financial reporting system could be improved in easy and coherent way by involving accounting professionals and supporting them with the guidelines for IC reporting. However, IC reporting practices have not advanced significantly in recent years despite a multitude of available reporting frameworks being available to companies (OECD, 2012). Perhaps, the lack of agreement among academics and practitioners on most aspects of IC reporting including what to report (or what is IC) and how to report, can be blamed for the current moribund status of IC reporting (Abhayawansa, 2014).

The starting point of any initiative seeking to harmonize measurement and reporting practices for IC should be the identification of best practices in the existing guidelines (Palacios & Galvan, 2007; Fadur, Ciotina & Mironiuc, 2011). Thus the present research conducted an analysis of various initiatives in the field of IC measurement and reporting which produced the following ideas of the reporting on the IC as a background for further research: **the new reporting model** should be established globally. This model should expand the 'traditional' financial reporting with the reporting requirements for IC. Therefore two aspects should be considered: **1) the development of internationally accepted standards for IC reporting** because harmonized norms and principles for IC measuring and reporting allow comparing the ICS built by companies (Campos & Ordonez de Pablos, 2007), and **2) the setting of globally mandatory disclosure of IC** because as there are no mandatory standards for IC, information disclosed voluntarily is also available to competitors, and competitive advantages can quickly disappear; therefore, the needs of the capital markets need to be balanced with the risk of competitors losing a competitive edge (Brennan & Connell, 2000).

According to the suggestion, the new reporting model in the reporting package would cover not only the 'traditional' financial accounts but also statements on the company's IC. An ICS without any reference to the financial data seems to be of little benefit (Alwert, Bornemann & Will, 2009). Consequently, a reporting package should contain two statements, one of which – ICS – is brief and concise. It is one to three pages long whereas the second statement represents notes or a complementary ICS report.

However, there is a challenge to create a persuasive ICS, as these statements are complex forms of reporting which combine numbers, narration and visualization, they do not only mobilize numbers and indicators, but also a story-line – a knowledge narrative – which describes the 'production function' of IC, and often a sketch, which provides an illustration of the work of IC (Bukh, Larsen & Mouritsen, 2001; Mouritsen, Larsen & Bukh, 2001). Therefore, two statements on IC are proposed in this paper: the first one – the ICS – should include some specific quantitative financial and non-financial indicators – KPIs – which relates to the sketch a set of certain numbers/ data points. The second one – the notes or the complementary report to ICS – should reveal the 'story' which communicates the company's functioning and includes other relevant explanations.

However, the attitude towards IC differs from company to company and its reporting is very much company and industry specific (Mouritsen, Larsen & Bukh, 2001; Beattie & Thomson, 2010). Therefore, a set of various KPIs valuating IC and allowing for comparability among companies has yet to be identified (Brennan & Connell, 2000). The problem is that IC management and reporting systems deliver various information and often a huge number of new indicators (Leitner, 2005). Therefore, only these KPIs should be included in the ICS which are (Palacios & Galvan, 2007): useful and relevant; significant, understandable and available; comparable and reliable; objective, verifiable and feasible.

The best way in setting these specific KPIs is to engage with stakeholders and other users of ICS; they can judge what works and what does not, and where additional disclosures may be needed (ICAEW, 2009). However, these indicators cannot be taken for granted – they must be verified through research and scientific determination so as to ascertain their reliabilities (Tongo, 2010). Since IC is unique to individual company or

industry branch, the describing indicators should be grouped. An example of grouping of KPIs proposed in this paper is presented in Table 3 (compiled by the author).

Table 3. Groups of KPIs presented in ICS.

A. Mandatory disclosures for all companies								
Human capital	This year	Last year	Organizational capital	This year	Last year	Relational capital	This year	Last year
<i>Assets</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Assets</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Assets</i>	<i>KPIs</i>	<i>KPIs</i>
...
<i>Liabilities</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Liabilities</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Liabilities</i>	<i>KPIs</i>	<i>KPIs</i>
...
B. Additionally mandatory disclosures for one specific industry branch								
Human capital	This year	Last year	Organizational capital	This year	Last year	Relational capital	This year	Last year
<i>Assets</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Assets</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Assets</i>	<i>KPIs</i>	<i>KPIs</i>
...
<i>Liabilities</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Liabilities</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Liabilities</i>	<i>KPIs</i>	<i>KPIs</i>
...
C. Additionally mandatory disclosures for other specific industry branch								
Human capital	This year	Last year	Organizational capital	This year	Last year	Relational capital	This year	Last year
<i>Assets</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Assets</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Assets</i>	<i>KPIs</i>	<i>KPIs</i>
...
<i>Liabilities</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Liabilities</i>	<i>KPIs</i>	<i>KPIs</i>	<i>Liabilities</i>	<i>KPIs</i>	<i>KPIs</i>
...
D. Additionally mandatory disclosures for another specific industry branch								
...

As seen from the Table 3 above, the main idea of grouping KPIs is related to IC structure: human, organizational and relational capital. Yet not only the asset side but also the liability side of company's IC should be disclosed as well. Each intellectual asset should have a corresponding intellectual liability counterpart that should be considered for fair presentation of a company's ICS. Otherwise, management self-interest could result in IC disclosures that overstate intellectual assets and understate intellectual liabilities (Tackett, Wolf & Kinsley, 2007).

The next idea of setting groups of KPIs is that basic indicators should be established (Table 3, Segment A) whose revelation should be mandatory to all companies. Additionally, specific data points should also be outlined for distinct industry branches (Table 3, Segments B-D) which should be additionally revealed by companies operating in the relevant industry branches. As a result, companies would be protected from the burden imposed by the disclosure processes whereas stakeholders would also benefit from getting more information since some industry-specific information would be revealed in the same way by all the companies operating in any specific industry branch; this would lead to enhanced comparability. Of course, all the mandatory indicators should be explicitly and extensively described and their meaning and purpose should be defined together with their target value, calculation algorithm, possibilities of interpretation as well as other aspects relevant to stakeholders and the enterprises themselves. These data points and data descriptors should be approved as internationally accepted standards for IC reporting and should be applied globally.

The last thing regarding the disclosed information in ICS is that the all KPIs should be presented for two years at least. Only in this way the data on IC (assets and liabilities) could be comparable and valuable to users of these statements.

After the inclusion of ICS in the reporting package, the obligation of the auditing of these statements together with the 'traditional' financial statements will be imposed. Therefore, independent auditors will be challenged because current standards are designed to audit 'traditional' financial statements rather than intellectual assets and liabilities (Tackett, Wolf & Kinsley, 2007). Such resources like IC, due to their nature, cannot be audited in the same manner as tangible assets. New procedures to validate the measurement techniques for IC need to be established (Brennan & Connell, 2000). Since the audit as the valuation method is applied, the defined quality criteria have to be easily auditable. Considering these preconditions, the five basic quality assessment criteria for auditing ICS could be classified, i.e. (Mertins & Wang, 2008): 1) completeness according to the requirements; 2) plausibility; 3) verifiability; 4) representative for the company and 5) sustainable regarding impact on IC management of the company. Hence, if internationally accepted standards for IC reporting are approved and introduced, they are expected to set forth requirements for IC reporting covering the outline and the content of the ICS, the procedure of KPIs calculation and similar elements whereas auditors will be provided with methodological assistance on the ways of verifying ICS. Thus, auditors are unlikely to face difficulties when applying slightly modified audit procedures in the process of auditing the correctness of the data presented in ICS. This results in the truthful and objective view of a company's IC.

In conclusion, the new reporting model based on the above listed principles would fulfill all the requirements set upon ICS by information users: 1) the information disclosed in ICS is **comparable** as its form of presentation and its content are structured and standardized not just generally but they are also specified in terms of industry branches; 2) it has a degree of **continuity** as mandatory standards of data revelation would be established and the same standards would be applicable to all the participants of the market; 3) the minimum **content** of the revealed information would be established including industry branch-specific data points (however, the development of specific KPIs was not conducted in this research); 4) the ICS is **clear and short**, which facilitates the information reading process; 5) the revealed information may be readily and easily **integrated** in financial valuation models; and finally 6) the disclosed information is more **credible and reliable** because of verification of independent auditor.

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