DOI 10.2478/vjes-2022-0017

A Critical Analysis of the Current Financial Statements and How they Manage to Provide or Imagine Faithfully to Complete the Market Value of the Companies

Cati-Loredana DUMITRU (SOARE)
George Ciprian GÎJU
Violeta Elena DRĂGOI
Larisa PREDA
"Valahia" University of Targoviste, Romania
soarecatiloredana@gmail.com

Abstract

Beyond international accounting standards, which recognize that there have been significant investments in intangible assets in recent decades and have complaints that do not identify investments in intangible assets in financial statements, distorts the assessment of companies' performance and does not allow for a fair evaluation of the market value of them, there are also numerous recent studies that confirm this. In today's knowledge economy, we find that the information provided by recent financial statements needs to be more sufficient for stabilizing strategies, decision-making, and the stability of the actual market value of companies. This article proposes a critical analysis of the current financial statements and how they manage to provide or imagine faithfully to complete the market value of the companies.

Keywords: *intellectual capital, faithful image, current accounting, intellectual capital accounting, market value*

JEL Classification : M40, M41, M42

Introduction

Intellectual capital is combined intangible assets owned or controlled by a company or organization, creating a competitive advantage for them. Intangible intellectual capital assets may include the knowledge and experience of employees, brands, customer relations, contracts, intellectual property, patents and copyrights, organizational technologies, processes, and methods. Intellectual capital can exist in an implicit and incorporeal form - that is, existing (stored) only in the memory of workers - or explicit and documented in a written or electronic form [Stan & Anghel, 2006: 5]

© Author[s] 2022. This work is distributed under the Creative Commons Attribution 4.0. License [http://creativecommons.org/licenses/by-nc-nd/4.0/]

The literature provides many other definitions of intellectual capital as follows:

- Intellectual capital is the collection of intangible resources [Bontis &Dragonetti, 1999: 391].
- Intellectual capital is the knowledge that can be turned into profit [Harrison & Sullivan, 2000: 34].
- Intellectual capital is a claim for future benefits that does not have a physical or financial embodiment [Baruch, 2001: 5]
- Intellectual capital is the possession of knowledge, applied experience, organizational technology, customer relations, and professional skills that provide a competitive advantage in the market [Edvinsson & Malone, 1999: 44].

The lack of an accounting of the intellectual capital of the enterprises always generates significant errors in management [Giju & Radu, 2014]. The world's largest companies, whose intellectual capital is growing over time, are facing difficulties in measuring human quality, customer loyalty, and the effectiveness of the organizational structure.

This situation significantly reduces the benefits of the enterprise by the fact that one can manage a large part of its intangible value precisely because of these measurement difficulties. One of the primary motivations for developing intellectual capital accounting in the mid-1990s was to explain the distortion between many businesses' market value and book value. In this situation, many listed companies have a market value ten times higher than the book value.

1. The traditional accounting system and hidden intangible assets

The current accounting system takes over historical information and aims to control and govern companies or organizations. But in the present context, the information provided by the recent financial statements is no longer sufficient. A complimentary situation regarding intangible assets is needed to help establish the strategy and make decisions. Thus, we can combine control with strategy, but we need an information system to evaluate and manage the enterprise.

The traditional accounting system is based on a historical perspective and uses just financial measures that accept the accurate calculation of the results. If we include information on intellectual capital in our financial statements, we conflict with the international accounting standards in force. Due to this, it is only possible to have in the current financial statements if they are presented as an extension of the financial statements.

Intellectual Capital is not recognized in the current financial statements because the criteria for defining and identifying assets currently established are pretty restrictive, and there are very few assets that can meet them; by IAS 38, intangible assets must meet the following conditions [IAS 38, 2021]:

- Controlled by the institution as a result of earlier circumstances.
- From which upcoming benefits are expected to influence the institution.
- Identifiable:
  - ✓ Separable, they can be divided and separated and sold, transferred, authorized, leased, or exchanged, either together or individually,
  - ✓ It arises from legal rights transferable or separable from the entity or other obligations and rights.
- Future benefits attributable to the asset are likely to accrue to the entity.

• The cost of an asset can be reliably measured.

Even the *Basis for Findings in IAS 38 - Intangible Assets* [IAS 38, 2021] recognizes that there have been significant investments in intangible assets in recent decagons. There has been criticism that:

• Non-recognition of investments in intangible assets in the financial statements distorts the evaluation of the performance of an enterprise and does not allow a correct assessment of the return on investments in intangible assets.

• Companies need to monitor better the return on investment in intangible assets to avoid an excess or deficit of investment in significant assets. An accounting system that encourages such behaviour will become an increasingly inadequate signal, both for internal control and external purposes.

2. Effects of not accounting for hidden intangible assets

The 1982 study by the Office of the Commissioner General of Planning (France) highlights the perverse products of recording profit and loss accounts of investment-related expenses and advocates a less rigid interpretation of the precautionary principle. The main side effects of this study are [Feleagă & Malciu, 2004: 131-133]:

a) The reading of the balance sheet asset needs to allow a correct assessment of the value of the enterprise. Goodwill does not accurately measure the intangible capital of an enterprise.

b) The abnormal increase in the general expenses item confuses the choice of the financing method. Empirical studies show that intangible investment financing is predominantly from own resources. Two reasons can explain this trend. First of all, managers are afraid to finance, through loans, expenses that, according to the accounting documents, belong to the operation. Second, bank lenders are reluctant to finance intangible investments because they consider them riskier than physical investments. As a result, intangible investment expenses are recognized in the income statement instead of the balance sheet.

c) The abnormal increase in the general expenses item deforms the management rates and the profitability calculations. It is evident that the recording of expenses that produce effects in the medium or long term in the enterprise's operating expenses leads to an overestimation of costs in the current period and implicitly to the distortion of calculated rates and the practice of an inadequate pricing policy.

d) The abnormal increase of the general expenses item leads to underestimating the fixed capital's gross formation, a macroeconomic indicator equal to the value of durable goods purchased by resident enterprises for use over a year. National accountants use only tangible assets as durable goods to calculate this indicator. However, things are evolving as the rules of the European System of Accounts (ESA 95) set out a new methodology for overcoming the material concept and integrating some of the intangible investments into gross fixed capital formation.

These are the research and development expenses related to the mining operations, the company's program products, some audio-visual costs, and some literary and artistic works destined to enter the commercial circuit. However, the new methodology represents only one stage because most intangible investments continue to affect intermediate consumption.

3. Proposal for the recognition of intellectual capital in the financial statements

Given the problems related to the evaluation and recording of intellectual capital in accounting, one solution would be to incorporate the information on intellectual capital as an annex to the annual financial statements in the form of a report. The premise from which we drew up this report on intellectual capital was to explain the difference between the market value of a listed company and its book value, which we called extra-book value. Initially, we attributed this extra-accounting value entirely to intellectual capital, and the tremendous global crisis manifested since the end of 2008 will make us revise this hypothesis.

The carrying amount can be attributed to the intellectual capital of an enterprise to which speculative market fluctuations are added or subtracted. Starting from this new hypothesis, we can propose an equation by which we establish the difference between an enterprise's market value and its accounting value [Peña & Ruiz, 2002: 135].

$$VP = VC + CI + FSP$$

where:

VP = market value; CI = value of intellectual capital;
VC = carrying amount; FSP = speculative market factors.

The market value is the type of value most often required of an appraiser. Suppose the valuation's purpose is to estimate a value other than market value. In that case, an extraordinary statement shall be made to warn the customer that that value should not be confused with market value. In our case, when dealing with a listed company, the market value will be calculated as the product between the number of shares and the price paid per share on the stock exchange. We will determine the book value of the enterprise based on the net accounting asset method, which is calculated based on the financial indicators from the last balance sheet. The net accounting assets represent the surplus of all the assets and receivables of the enterprise (assets) over all its debts (due liabilities). They are determined according to the formula [Peña & Ruiz, 2002:138]:

$$Net\ accounting\ assets = Assets - Liabilities$$

The value of the intellectual capital is determined by summing the value of its components already defined in the previous subchapter according to the following formula:

$$CI = CU + CS + CR,$$ where:

CI = value of intellectual capital. CS = value of structural capital;
CU = value of human capital; CR = value of relational capital.

The situation of hidden intangible assets (intellectual capital) should include information such as [Starovic & Marr, 2004]: i. A brief description of the company, ii. Challenges and actions of the company's management, iii. A set of non-financial and financial indicators. The brief description of the company gives organizations space to strategically explore their goals, the products they sell, and their approach to the customer. It also helps identify hidden intangible assets and describes how they lead to performance and provide value to all stakeholders. The second part of the situation of hidden intangible

assets (intellectual capital) includes information related to the challenges and actions of the company's management, identifying which intangible assets must be consolidated or acquired to reach strategic objectives. Allows the company to report on activities, initiatives and processes, either existing or planned for the future.

The third part of the report includes a set of financial and non-financial indicators, grouped on the components of intellectual capital [Peña & Ruiz, 2002:138]:

• Human capital: investments in the salaries of qualified personnel; investments in staff training and development; assets in employee recruitment and selection; temporary employees/permanent employees' indicator; employee satisfaction index, employee motivation index; promotion index; training-performance index.

• Structural capital: investments in quality and evaluation; suggestion index; administrative efficiency/revenue; customer satisfaction index; investment in research and innovation; investment in workstation equipment; investments in the development of new products; investment in process development; technological index.

• Relational capital: investments in communication and marketing; investments in cultural support and solidarity projects; works performed by third parties (subcontracting); investments in after-sales services; customer satisfaction index; the image index of the enterprise.

4. Advantages and limitations of the intellectual capital report

The Intellectual Capital Report as an annex to the financial statements would have the following benefits:

• *It is increasing the quality of accounting information*. Including a more significant number of intangible assets as an extension of the financial statements allows for much closer estimates of the company's ability to generate future profits, facilitating investment decision-making, increasing the possibilities for financially reflecting the value of companies, and reducing uncertainty.

• *Allows comparability*. Calculating intellectual capital in monetary units allows the comparability of data with other enterprises in the same sector of activity and its evolution over time.

• *It allows us to explain part of the difference between the accounting value of an enterprise and its market value*. We are aware that the extra-accounting value of an enterprise is not entirely due to its intellectual capital but also depends on certain speculative factors of the market.

• *It allows us to obtain a coherence between accounting and the current economy*. Only with a good correlation of investments in tangible assets with those in intangible assets can the company get a competitive advantage over the competition.

• *It allows the correlation of the present with the future of the enterprise*. In the report, the financial indicators show the company's future orientation, while the efficiency indicators reflect the materialization of previous investments (direction towards the present).

Conclusions

The traditional accounting system is based on a historical perspective and uses just financial measures that accept the accurate calculation of the results. If we include information on intellectual capital in our financial statements, we conflict with the

international accounting standards in force. Due to this, it is only possible to have in the current financial statements if they are presented as an extension of the financial statements.

The lack of an accounting of the intellectual capital of the enterprises always generates significant errors in management. The world's largest companies, whose intellectual capital is growing over time, are facing difficulties in measuring human quality, customer loyalty, and the effectiveness of the organizational structure. This situation significantly reduces the benefits of the enterprise by the fact that one can manage a large part of its intangible value precisely because of these measurement difficulties. One of the primary motivations for developing intellectual capital accounting in the mid-'90s was the need to explain the distortion between many businesses' market value and accounting value. In this situation, many listed companies have a market value ten times higher than the book value.

Acknowledgment: *This work is supported by project POCU 153770, entitled "Accessibility of advanced research for sustainable economic development- ACADEMIKA", co-financed by the European Social Fund under the Human Capital Operational Program 2014-2020.*

References

Baruch L., (2001*) Intangibles: management, measurement, and reporting*, Brookings Institutions, Virginia

Bontis N., Dragonetti N., Jacobsen K., Roos G. (1992) *The knowledge toolbox: A Review of the Tools Available to Measure and Manage Intangible Resource*". European Management Journal Vol. 17 No 4, pp 391-402

Edvinsson, Leif; Malone, M.S. (1999), El capital intelectual. Como identificar y calcular el valor de los recursos intangiblews de su empresa, Gestion 2000, Barcelona

Creţu, R. F. (2017). *Analiza capitalului intelectual–resursă esențială în economia creative*. Economica, 100(2), 83-88.

Feleagă, N., Malciu, L., (2004) *Provocările contabilităţii internaţionale, la cumpăna dintre milenii. Modele de evaluare şi investiţii imateriale*, Editura Economică, Bucuresti

Giju, G. C., & Radu, M. (2014). *Recognition of Intellectual Capital in Contemporary Financial Statements*. Valahian Journal of Economic Studies, 5(2).

Harrison, S. & Sullivan, P.H. (2000), *Profiting from intellectual capital – learning from leading companies.* Journal of Intellectual Capital, 1(1), 33-46, p.34

IAS 38 (2021) - Intangible assets, *Recognition of internally generated intangible assets*

Marr, B., Schiuma, G. (2001) *Measuring and managing intellectual capital and knowledge assets in new economy organisations*, in Handbook of Performance Measurement, M. Bourne (ed), Gee, Londo

Peña, D. N., & Ruiz, V. R. L., (2002) *El capital intelectual: valoración y medición: modelos, informes, desarrollos y aplicaciones*. Pearson Educación.

Roos, J., G. Roos, N. C. Dragonetti, and L. Edvinsson, (1997) *Intellectual capital, Navigating new business landscape.* Houndmills: Macmillan Press

Starovic, D. and Marr, B (2004) *Understanding Corporate Value: Managing and Reporting Intellectual Capital*. The Chartered Institute of Management Accountants (CIMA) and Cranfield University, London.

Tabirca, A. I., Radu, F., & Radu, V. (2020). *The Historical Evolution of Research in Accounting. National and European Context.* Ecoforum Journal, 9(1).