

Management and Communication of the Companies' Knowledge; Guidelines for Intellectual Capital Statement

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ABSTRACT

This paper¹ aims at analyzing the development of guidelines on Intellectual Capital Statement, providing a comparison of them and presenting their importance within the knowledge management process of the today's companies.

We entered the Knowledge Era in which the basic economic resources are no longer financial capital, physical resources, or labor, but knowledge, called also intellectual capital (IC). Many analysts and investors demand for more information and they highlight the gap that exists between the information found in companies' annual reports and the financial information regarding intangible part of the company requested by the market. Knowledge of the company should be measured and the effects should be communicated, as measurement without any further action has no sense. Intellectual capital statement seems an appropriate tool for that and becomes an integral part of the knowledge management of the modern enterprise. This kind of statement emphasizes the role of IC in relation to the value creation and communicates how knowledge resources are managed in the firms within a strategic objectives.

This paper compares different approaches to IC statement preparation: underlines similarities and differences concerning the scope, methodology and terminology used and ensuing consequences. It raises significant implications for managers of the companies, researches and policy makers.

Keywords: Knowledge management, intellectual capital statement, guidelines

1. INTRODUCTION

Organisations are facing a new phase in economic development, which is characterized by the prevalence of innovation, especially in high technology, in spread of communication, in new organizational forms and intangible factors creating added value for companies. They operate within the so-called knowledge economy. As Mouritsen, Bukh and Marr (2005) underline, "the advent of the knowledge economy has increased the importance of knowledge – based resources. However the majority of these resources are not reported in the traditional balance sheet. This has created an information gap in the market, and more firms and organization are calling for voluntary disclosure of these knowledge-based resources and intangible assets to close the gap". Many authors, like Eccles and Mavrinac (1995), Lev and Zarowin (1999) Amir and Lev (1996) underline that there is a lack of relevance of the accounting information, thus leaving investors without appropriate information for decision-making process. In order to make financial reporting of companies more relevant for investors, the financial statements should give more attention to intangibles. Descriptive report of intangibles should supplement

the financial statements making the generated information more transparent and better reflecting market value. Therefore many international institutions, research centres and governments of many countries and even European Commission devoted a substantial resources to analysing the ways of knowledge management and their proper communication to the market. As the effect of these efforts a few sets of guidelines on IC reporting have emerged. Hundreds of European companies put them into practice.

Mouritsen, Bukh, and Marr (2005) underline that: "The purpose of the IC statement is often two fold, as it functions as a management tool used internally in the firm and as a communication tool used to communicate how the firm works to develop its knowledge resources to generate value. Developing such statements improves the internal understanding of which resources are important and how they are combined and managed to create value".

2. KNOWLEDGE AND INTELLECTUAL CAPITAL

We can find many definition of what is knowledge and knowledge management and how it regards intellectual capital. For now, managers should choose the definition that best suits the needs of their particular situation and what problems they hope to solve deploying it (Berry, 2004). Knowledge management can be defined and described as follows: "Knowledge Management relates to the creation of value, the harvesting of ideas, the mining of employee brainpower, and the conversion of tacit knowledge into explicit knowledge that the organization can codify and transfer" (Al – Ali, 2003). Another definition says: "Knowledge management is the process through which organizations generate value from their intellectual and knowledge-based assets". (www.cio.com/research/knowledge/edit/kmabcs.html).

Terms "knowledge management" and "intellectual capital" are closely related. Sveiby (2001) says: "A term is best defined by its use, and therefore it is probably still correct to regard intellectual capital and knowledge management as twins – two branches of the same tree (...). IC is static and needs a verb to describe what managers can do with it: like managing IC or improving IC (...). KM is already active, in that it contains a verb". Sveiby (2001) gives his own definition of KM – the art of creating value from intangible assets.

The recent approach to the valuation of intangibles is based on the concept of intellectual capital. The broadest definition of intellectual capital is "the difference between a company's market value and its book value" (James, 1997). In a narrower sense, intellectual capital is "the sum of the knowledge of its members and the practical translation of this knowledge, that is brands, trademarks and processes" (Roos *et al.*, 1997).

3. KNOWLEDGE ERA AND CHALLENGES FOR ACCOUNTING

Intellectual capital regards to widely understood intangibles. How intangible assets differ from tangible assets? Saint-Onge (2000) underlines that: tangible assets are required

¹ Financial support acknowledged to the research grant for 2007/2008 of the Ministry of Science and Higher Education, Research Project number N 113 003 32/0079

for business operations and are readily visible, rigorously quantified, and are represented as a line item on a balance sheet. The intangible assets are key to a competitive advantage in the knowledge era and are invisible, difficult to quantify, and not tracked through traditional accounting practices. In the XXI century, the knowledge became the main driver of value creation of enterprises and the main factor of success. The concept of "New Economy" emerged, in which still increases the share and importance of intangible resources in the value creation process of the companies; investments and innovations concerning intangible resources play a dominant role. The main source of economic value added are always more human beings and information, relationships with partners and companies' ability to be innovative than financial capital. However only few percentage of the value of the company can be explained by the assets' book value published in financial statements.

According to Tollington (1994), balance sheet in the way it is constructed today leads to distortion of certain elements to such a degree that it cannot be accepted any longer and must be revealed, if professional credibility is to be preserved. The utility of traditional accounting and reporting is declining (Roslender, 1997). The usefulness of reported earnings, cash flow and book (equity) values have been deteriorating over the last 20 years (Lev and Zarowin, 1999).

Generally, the accounting rules have a very stringent definition of intangible assets that excludes many commonly accepted intangibles, like investments on training and advertisement, knowledge of the company, customer satisfaction, skills of employees, image of the company, as they do not pass the recognition test. As Al-Ali notices: "Financial reports and statements are far from accurate in communicating the real value of the enterprise and its future performance potential. Companies that are publicly traded are valued by the market at multiples of their book value, sometimes as high as 20 times (...). When nearly 80 percent of corporate business assets are made of intellectual capital, and where financial reports report only 20 percent tangible assets, one starts to wonder about the accuracy and efficacy of these reports in reflecting the value of the enterprise and its future performance potential".

Firm such as Microsoft and Coca Cola report only their traditional assets in their balance sheets, which account for an only small fraction of their market value. Even for manufacturing firms, such as Honda or BP, the assets in the balance sheet represent less than 30 % of the market value (Mouritsen, Bukh, Marr, 2005). If intellectual capital is an important component of the market value of a company and its disclosure is random, non systematized and mainly voluntary, the investors' decisions will likely be based, in part at least, on unreliable and non-comparable information.

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. They must meet the challenge of modification in order to become helpful in development, communication, monitoring and evaluation of the company's strategy. The proper communication of company's intellectual capital, incurred investments on it, its role and value is the challenge for accounting. It is necessary to create a new approach for measurement and disclosure of those elements that are crucial for a company. Measurement of these elements would enable their control and understanding of their strong points as well as risk concerning them. The effects of measurement should be communicated. The proper tool for such communication and visualization of effects regarding intangible resources is the intellectual capital statement.

This is a statement reflecting in a better way the market value of the enterprise and embracing those elements that in traditional financial statements are unevaluated or totally omitted. It usually has a form of a supplement for the yearly financial statement, in which it is documented and explained the strategy of the company, concerning the knowledge management of the enterprise and the activities regarding the realization of this strategy.

Summing up the main challenges facing accounting in the Knowledge Era are:

1. identifying critical intangible resources,
2. finding the right method to measure them and to manage them in order to improve the competitive position of the firm,
3. develop a way of communicating information to the inside and outside interested parties (intellectual capital statement),
4. harmonization and comparability of the used approaches and data presented in the global aspect.

Intellectual capital statements can help organizations to better manage, understand and communicate their knowledge resources and the value creation processes.

4. BENEFITS AND DIFICULTIES CONCERNING IC REPORTING

Price Waterhouse Coopers claims that there are following main benefits of measurement and reporting of intellectual capital: increased transparency of information presented by the company, lower cost of capital, higher price of shares, bigger confidence among employees and other stakeholders, affirmation of the long-time vision thanks to better communication, the possibility of using this kind of statement as a marketing tool. Other benefits may be as follows: decrease of insecurity concerning the future of the company, simplification of more – precise valuation of the company (Botosan, 1997), increased liquidity on the share market and higher demand for shares of the company (Healy i Palepu, 2001).

Starovic and Marr (2003) mention following adverse results of the lack of public information concerning intellectual capital of the enterprise:

1. smaller shareholders may be disadvantaged, as they usually have no access to information on intangibles often shared private meetings with larger investors (Holland, 2001),
2. insider trading might occur if managers exploit internally produced information on intangibles unknown to other investors (Abody and Lev, 2000).
3. stock market liquidity and increased demand for companies' securities is enhanced by greater disclosure on tangibles (Diamond and Verrecchia, 1991).
4. volatility and the danger of incorrect valuation of firms is increased which leads to investors and banks placing a higher risk level on organizations
5. costs of capital is increased, due to, say, higher risk levels placed on companies (Lev, 2001).

However, there are also some factors that may discourage the management from reporting and releasing to the public information concerning intellectual capital. Among others, these are:

1. presentation outside of the company information, concerning maintenance of competitive position,
2. leaving a space for information manipulation,

3. creation of risk concerning the credibility of information for its users, as the information regards future that cannot be predicted precisely,
4. the increase in the operational cost as the result of new rules and greater bureaucracy.

Baruch Lev (2001), while explaining the skepticism in the intellectual capital statement underlines, that the value of intellectual capital is very subjective and on contrary to physical assets they may disappear in the short period of time. Therefore, it could contribute more to the increase of uncertainty among investors and managers, than of being helpful. However, Lev underlines in the same time that this skepticism is exaggerated and denying the measurement and the lack of intellectual statements is for long-term achievements of the company substantially bigger problem. Intellectual capital statements can help organizations to better manage, understand and communicate their knowledge resources and the value creation processes.

5. GUIDELINES ON IC REPORTING

The attempt of meeting the challenge of new reporting, that would translate and explain the intellectual capital based process of value creation in the enterprise was the independent emergence of set of guidelines, that as the main objective have to facilitate preparation of intellectual capital statement. They do not introduce any changes to the accounting law and as for now they are the trial that aims at testing certain particular methods on IC measurements and disclosure. IC statements, created on the basis of IC guidelines, aim at underlining the role of IC in the value creation process and are a tool of communication what is the knowledge management of the enterprise within chosen strategy. They are in the same time an integral part of the knowledge management presses. They describe the strategy of knowledge management in the enterprise, its objectives, initiatives and the results of creation, application and development of the knowledge resources of the company.

The main and more frequently used guidelines are IFAC Study no 7 (1998), the Danish Guidelines (2000, 2003) – “A Guideline for Intellectual Capital Statements”, Nordika Guidelines (2001) – „Intellectual Capital – Managing and Reporting”, and the Meritum Guidelines (2002) – „Guidelines for Managing and Reporting on Intangibles”.

IFAC Study no 7 „The Measurement and Management of Intellectual Capital – An Introduction” 1998 - this study was commissioned by the Financial and Management Accounting Committee (FMAC) of the International Federation of Accountants (IFAC) to discuss some of the major issues concerning the measurement and management of intellectual capital and the accountant's role in this process. It is intended to provide an introduction to the accounting challenges and opportunities associated with intellectual capital management by discussing its underlying concepts and describing merging practices (Del Bello, 2002).

Danish Guidelines (DATI) (2000,2003) - These guidelines are the results of a collaboration of researchers, more than 100 companies, public and industrial organizations and consultants and they were coordinated by the Danish Ministry of Trade and Industry. These works were also in the field of interest of European Union and OECD. The research concerning the development of these guidelines started in 1998 and they were finally published in 2000. In 2003 a new version of guidelines was published. Since the moment of publication of the first

DATI guidelines in the November of 2000, about 100 private companies and public organizations tested them. The conclusions were that preparation and publication of the intellectual capital statement contributed to better knowledge management in the companies and was an important tool of communication with the outside stakeholders.

Nordika Guidelines (2001) - Guidelines prepared within Nordika project are the effect of cooperation participants of the Nordic project concerning the measurement of intellectual capital from the Nordic Industrial Fund, representatives of the Governmental Task Forces and a Round Table drawn from business and professional associations in the Nordic countries. The Nordic guidelines give companies the overview of possibilities and main approaches, concerning the managing and reporting of knowledge management. They provide also some examples of Nordic companies that have worked with implementing the intellectual capital management and reporting and present some cases, illustrating their experience in producing IC statement. Similarly to the guidelines proposed by IFAC, Nordika does not suggest a concrete structure of the intellectual capital statement, however presents the list of issues, that the statement should include:

1. general function of knowledge (connection between the company and the market, products and clients, relation between knowledge and other intangible resources, the impact of knowledge in the value creation process),
2. market chances, objectives and challenges,
3. resources,
4. activities (company's activities concerning the use and development of its intellectual capital),
5. relations,
6. concentration on the non-financial elements therefore not focusing exclusively on the physical and financial assets (consequently, the measures may be financial and non-financial),
7. indicators (more than just numbers, they should explain and visualize the effects of activities through an illustration and graphic charts),

Meritum Guidelines (2002) – they have been prepared within the project *Measuring Intangibles to Understand and Improve Innovation Management*, which has been funded by the European Union within the framework of TSER (Targeted Socio-Economic Research) Program. The project was embracing researchers from 6 European countries (Denmark, Finland, Norway and Sweden, Spain and France). The logic effect of the process of knowledge management is the preparation of the report that would communicate to its users information on abilities, resources and activities in respect to the fundamental determinants of the enterprise's value. The intellectual capital report has three different parts: vision of the firm, the summary of intangible resources and activities, the system of indicators.

6. THE COMPARISON BETWEEN PRESENTED GUIDELINES ON IC REPORTING

As a first conclusion it should be emphasized that all the guidelines have more similarities than differences. Using one or another should not result in significant differences as far as the main content is concerned. The practical purpose and aim of IC reporting, no matter of on which guidelines it is based, is to

provide management with a tool for monitoring and disclosing information about their activities and efforts to manage the company's knowledge base.

As we can find in the introductions to the Nordika guidelines: "The various approaches to IC reporting deal with how to make systematic measurement of a range of intangible assets – each of them using a set of IC categories and indicators. The procedures and techniques involved are designed to provide a long-term perspective: (...) they are forward-looking management tools, serving to highlight and advance the strategic goals of the company. Concerned as they are with aspects of knowledge management they are also related to change stemming from the emerging knowledge economy and they are designed to help management keep the company on track".

Consequently, the approach to the value creation combined with differences in knowledge definition, and regarding it concepts and categories, will make the choice of information to be reported and disclosed very different. In principle, the differences mean that:

- the Study no. 7 of IFAC is the first set of guidelines on the intellectual capital statement and it was mainly created in order to help in choosing the right method of measurement followed with preparation of intellectual capital statement. Moreover it was supposed to signal the importance, rise an interest and create more understanding to that still quite new concepts in 1989. IFAC guidelines did not introduce any new specific rule or recommendations, they focused mainly on presentation of what was already done in the international field. It leaves the companies the possibility to choose the way of measurement and presentation of knowledge based information that suits them best.
- While adopting Danish guidelines, the enterprise puts the focus on the knowledge management that leads to "value in use" – value for users of its products and services, relying not on a single factor but on multiple factors – resources and activities – and the relations between them. Narrative knowledge and the management challenges define, what should be measured and determine, which indicators should be used. The categories of indicators should embrace customers, employees, processes, and technologies and what should be measured are the constellations of resources and concerning them activities. The priority of indicators is to explain in which way the company may prepare its IC statement.
- According to Nordika project, the IC report should explain when and how we can find in the company the key resources and how they are used in order to create the value.
- "Using the Meritum approach will bring into focus how the company – through the connectivity of critical intangibles in a network – pursues its strategic objectives and by this focuses on how to create value for users and other stakeholders." (Nordika Project, 2002). These guidelines put special attention to both internal and external reporting, the indicators adopted are aimed at presenting what activities concern the company's intangible resources. The information provided should enable its users to evaluate if the company realizes its strategic objectives in a proper way. The proposed indicators should be applied to all three categories of intellectual capital (human, structural, and relational)

All the above described sets of indicators make an attempt to present, how the company should systematically perform the

measurement of intangible resources using the proper categories of IC and appropriate indicators. All the proposed indicators present procedures and techniques, that are future-oriented tools of management and serve to underline strategic objectives of the company. Even though these guidelines are not ultimate and do not clear all the doubts concerning the difficult issue of intellectual capital reporting, they are highly valuable help for companies in:

1. definition of the company's vision,
2. describing, what kind of resources has a company at its disposal and which of them should increase or strengthen,
3. they contain a minimal set of indicators for intangible resources concerning their activities measurement,
4. they facilitate the grouping of information in order to help in intellectual capital preparation.

One of the most important elements that all guidelines have in common is the acceptance of the central role of the IC statement in the process of value creation. Generally we can notice that according to all analyzed guidelines these statements have the objective of not only evaluating the IC but also, and even in many cases mainly, description of the importance of the IC in the process of value creation. All these documents admit the usefulness of IC statement both to the internal as well as external use as a tool of communication.

Within all analyzed set of guidelines, the role of the management as the most important body in the enterprise in the process of implementation is especially underlined. This process is almost in all cases literally defined as the "learning process". In all the guidelines it is also highlighted that the indicators used in the intellectual capital statement should not only serve in order to measure and evaluate but also to visualize the intellectual capital. IC statement should cover all the knowledge resources of the company and their interactions and relations and should describe the activities that are performed in order to develop them. None of the analyzed documents presents the complete and closed list of indicators, however all of them include some examples of the categories of indicators suggested. These indicators, depending on the guidelines adopted by the company slightly differ.

Even though guidelines usually does not present a definition of what is knowledge, however all admit that knowledge is the most important component of intellectual capital. Presented approaches describe differently the way knowledge contributes to the value creation and how it is placed within this process. All the approaches aim to capture process which are dynamic and systematic in nature and they underline the necessity of reflecting this dynamics.

According to Del Bello (2002), "another area of convergence relates to the long-term perspective assumed by the proposed procedures and techniques. Furthermore, all the documents stress the firm – specificity character of IC and, consequently, of its indicators".

Important differences between the analyzed guidelines are mainly about value creation, how the concept of knowledge is apprehended and the categories used for indicators when disclosing information. As far as value creation is concerned all the guidelines admit the principal role of knowledge however the procedures of implementation and phases, in which the knowledge is transformed in company's value are different. The discrepancies can be also observed in the scheme of information presented in the IC statement.

The general objectives of guidelines are also slightly different. IFAC guidelines aim generally at signaling the importance of intangibles and IC and therefore the necessity of reporting them. IFAC concentrates also on the presentation of

already existing methods regarding measurement and IC reporting. Danish guidelines have a very practical character, focus mainly on presentation of IC statement preparation; they include a wide range of indicators, that are used most frequently in practice, with their explanation and ways of interpretations. The language used in these recommendations is very user-friendly. The Danish guidelines put main stress on their practical usefulness even at the cost of some terminological simplifications or theoretic imperfections (lower cohesion and consequence in used terminology). Meritum project, however, at first presents a management model and the as the result of management it presents a statement on IC. Therefore we can assume, that Meritum guidelines consider IC in a wider dimension, starting from management processes and only after that proceeding with the reporting processes. IC statement is understood as the logical effect of intangibles management processes. Also the Danish guidelines refer to management but in the more indirect way.

Theoretical bases of Meritum guidelines are very strong, the authors of these guidelines are in the main part researchers, scientists, and academics. Therefore the language used is more precise, more strict and accurate but also sometimes less understandable for the „average” manager. Therefore they are more coherent, have a deeper conceptual framework which is widely acceptable but some claim (Garcia-Ayuso in Guimon, 2002) that they are more abstract, more theoretical, harder to apply and less didactical”. As Mouritsen (in Guimon, 2002) says: „the strength of the Danish guideline is that they are more user – driver, more practical, more implementable”, while „the main value of the Meritum guidelines is the knowledge and consensus that was built among the different countries which were involved”.

While the guidelines are describing the same process, they use a little bit different terminology, which unfortunately may lead to the confusion. Danish guidelines generally use the term „intellectual capital statement”, whereas the Meritum, Nordika, and IFAC use the expression “intellectual capital report”. What is the difference between the “statement” and “report”? The authors of Meritum guidelines, while motivating why the term “report” is preferable by them underline, that this word “denotes a voluntary character, whereas the term “statement” is associated with the traditional financial statement that are compulsory and must convey to a given format” (Guimon, 2002). However Mouritsen, one of authors of Danish guidelines does not agree and says that “report to me sounds as if it something that has a fixed format of reporting a certain issue, while statement is an expression, and therefore has more narrative nodes to it than a report” (Guimon, 2002). Table below presents some other differences in the language used in the guidelines, on the example of Meritum and Danish guidelines:

Table 1. differences in the Meritum and Danish guidelines language

MERITUM GUIDELINES	DANISH GUIDELINES
Intellectual capital report	Intellectual capital statement
Intangibles management	Knowledge management
Vision of the firm & strategic objectives	Knowledge narrative
Critical intangibles	Management challenges

Source: Guimon, 2002

Generally we can conclude that the basis, main concepts and ideas presented in all guidelines are very similar. Del Bello (2002) underlines that “the weight of the emerging convergence

appears greater that of the identified differences, since the analyzed documents agree upon the most important issues, which are the results that we are looking for through the IC report and its role in the value creation process. What differs between the documents is essentially the choice of the pattern to reach those end-results”.

SUMMARY

Today, the need of identification of the proper methods of intellectual capital valuation becomes more important than ever before. More and more companies, despite the mandatory requirement, has decided to present in their financial statements those resources, that are considered by them key in the value creation process and that within binding accounting rules are not subject to obligatory disclosure.

Doubt and reservation of other companies, concerning action in order to measure and disclosure intellectual capital may be explained as there is the conviction that accounting should meet requirements of protecting public interest. Therefore, it should be coherent, objective, possible to verification, the subjective element should be reduced and no space for manipulation and for opportunism left. In the same time, if accounting practices want to keep pace with the speed of changes in the environment and surrounding of companies and if they are to truly and fairly reflect the value and position of the companies’ in the Knowledge Era and to communicate it in the proper way, one of the main challenges facing accounting is to include intellectual capital in the system of its measurement and disclosure.

The guidelines presented in this paper are the important step in creating consistency and in harmonization of the practices in that field and should be used as a help for companies in the communication of their knowledge. They were also an inspiration for other guidelines or documents of similar character, mainly on the national range, like: Spanish guidelines „Intellectus Model ®” from 2003, German guidelines: „Wissensbilanz” from 2004, Japanese guidelines „Guidelines for Disclosure of IA Based Management” from 2005, Australian guidelines “Guiding Principles on Extended Performance Management, “A Guide to Better Managing, Measuring and Reporting Knowledge Intensive Organizational Resources” from 2005, Austrian guidelines “ARC IC Report” updated in 2005, Operating Financial Review in the UK from 2005.

Maybe in the future they will lead to the creation of the generally accepted unified and binding standard of cohesive homogeneous and comparable way of presentation of that important and difficult issue. There is still much to be done and much work is needed towards an international framework and a set of internationally harmonized guidelines, but the first important step has been done. The process of developing and implementing internationally accepted guidelines to report on intangibles is a very long process on which many different parties need to agree, and which has to be useful for many different purposes. As for now, presented guidelines are used as the voluntary standard of measurement and communication of their knowledge in hundreds and hundreds of companies.

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