



Enhanced business reporting: international trends and possible policy directions

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Abstract

Purpose – This paper seeks to examine contemporary trends in enhanced business reporting (EBR) and the development of a policy agenda for EBR. The paper aims to build on a submission to the US Securities and Exchange Commission (US SEC) advisory committee on improvements to financial statements (Pozen Committee).

Design/methodology/approach – The paper takes the form of a literature and policy review of intangible assets and intellectual capital.

Findings – Developments in the area of EBR will require to stand the test of practice, policy and research. The paper identifies five areas where recommendations would be welcome. First, the vast diversity in international EBR practice indicates that producers and users struggle with its implantation, suggesting concerns for international harmonisation. Second, the vast diversity in measurement and reporting models also suggests ambiguity about the content of EBR, raising questions as to how EBR techniques might be consolidated. Third, while experimentation with EBR has been increasing in several countries, limited practical insights have been derived from US companies. Fourth, greater visibility needs to be given to EBR, to increase its practical uptake. Fifth, research needs to be focus more on harmonisation. There is a need for further research about the barriers to, and consequences of, harmonisation including analyses of how the diverse frameworks “actually” differ.

Practical implications – This paper informs contemporary debate about EBR and especially the US SEC advisory committee on improvements to financial reporting (Pozen Committee).

Originality/value – This is a study into the contemporary international initiatives and relevant research into EBR, specifically from Europe and Australia.

Keywords Intellectual capital, Intangible assets, Financial reporting

Paper type General review



1. Background

In August 2007, the US Securities and Exchange Commission (US SEC) established the Advisory Committee on Improvements to Financial Reporting (Pozen Committee)[1]. The Committee's objective is to examine the US financial reporting system and to provide specific recommendations as to how unnecessary complexity in that system could be reduced and be made more useful to investors. A Subcommittee was established to discuss key performance indicators and enhanced business reporting (EBR) on the part of publicly traded corporations. This paper represents part of a

submission to this subcommittee, outlining initiatives similar to EBR outside the USA and relevant research internationally on EBR and intangible assets/intellectual capital, specifically from Europe and Australia. The authors acknowledge the support of the Society for Knowledge Economics, Australia, funding from the Faculty of Economics and Business at The University of Sydney and the assistance of Fiona Crawford of The University of Sydney.

2. Introduction

The information requirements of business executives and financial markets are shifting and interest in EBR information is increasing. The changing information requirements accompany broader economic transformations and the transition from an industrial society to a knowledge intensive, globalised economy, where intangible resources increasingly drive wealth creation and economic growth. This requires us to consider what form EBR should take (Mouritsen, 2007; Ricceri and Guthrie, 2008). Do we need a global standard? Which EBR frameworks are most beneficial to users and producers? What kind of regulation should be established? Such policy questions are increasingly important because, as we will suggest, there may be significant costs to firms and societies if this challenge cannot be met. One concern is what direction policy should take. In the financial accounting area, it seems that policy is organised tightly around the development of International Financial Reporting Standard (IFRS) and the accounting procedures associated with recognition of financial transactions. It may be that in the area of EBR, it is not possible to be this specific because the objective of EBR is still evolving. Is it a specific reporting format or is it an umbrella that will encourage many frameworks to co-exist? Another concern is how policy should regulate more boundary conditions. In particular, it may be that EBR is understood by far fewer users and producers than the financial accounting framework. Interestingly, the financial accounting framework requires that hundreds of thousands of people are educated about financial statements and then these people, after some years of practical training, are able to learn to produce and read financial statements. Currently use of EBR does not have the same level of educational requirement, which raises the question as to how this enables or hinders the uptake of EBR practices.

A survey of 1,016 company directors by McKinsey Consulting (2005) shows a shift in company directors' information requirements (Table I) and that there may be a demand for EBR information. According to the survey company directors are looking for more information about intangible resources including, for example, customer

1. Market health	Customer profitability/satisfaction, competitors' market share and products, suppliers, brands
2. Organisational health	Employee retention/satisfaction, capabilities and skills, organisational structure, culture, values
3. Network health	Regulatory changes, government policies, public opinion, community views
4. Financial performance	Cash, costs, EBITDA, margins, return on capital
5. Operational health	Buildings, inventories, patents, product pipeline, production rates

Note: Items shown are the 1,016 company directors surveyed in the McKinsey survey wanted to know more about, in order of importance

Source: McKinsey (2005)

Table I.
Changing information
requirements of company
directors: facts at a glance

relations, employee satisfaction and network and operating health. The survey also points out that the current lack of information about intangible assets may compromise the ability of company directors to fully understand the objectives and risks of their companies. This shows that there may be a demand for information.

Accenture's (2003) global survey similarly finds that company directors and others lack information about intangibles. The survey shows that only 5 per cent of companies have in place "a robust system that measures and tracks the performance of intangibles". This contrasts to 49 per cent of company representatives who said that intangible assets are what their companies primarily rely on for shareholder wealth creation. This shows there is a need for knowledge about how to make sense of the firm's intangible resources with a view to improve business decision making and investment. Thus, firms are not generally able to track investments in, and effects of, intangibles, which may be a hindrance to firms trying to justify innovation and investment into knowledge resources.

On a similar note, 92 per cent of participants in a Deloitte (2004) survey warn that traditional financial indicators found in financial statements are not enough to capture their companies' strengths and weaknesses and call for increased disclosure of EBR information. Although financial measurements received a high rating from survey respondents in helping the board and CEO make short-term decisions and in formulating strategy, such data were considerably less helpful in making mid- and long-term decisions and in achieving an appropriate valuation in capital markets[2]. This represents another recent recognition that the financial statement, important as it is, tends to deflate the complexities of modern corporate activities. It may not readily inform producers and users of the innovative capabilities residing in and around the firm.

Traditionally, a company's financial statements have been the cornerstone of investment decision making and performance evaluation. However, the findings of the studies by McKinsey, Accenture and Deloitte pose a question as to whether financial statements provide sufficient information for business decision making in a changing economy. This is consistent with academic research, which has started to question the relevance of financial statements in the knowledge era (Mouritsen *et al.*, 2003; Lev and Daum, 2004 for a US perspective). Ballow *et al.* (2004) explain that a lack of accounting for intangibles has resulted in a gap between market and book value. In 1980, the book value of the S&P 500 was 80 per cent of market capitalisation, whilst in 2003 it was less than 33 per cent. Consider also that, in 2008, Google's market capitalization is approximately US\$125 billion while its net tangible assets are worth US\$9 billion. Amazon.com has a market capitalization of US\$13.6 billion and a net tangible asset value of US\$76 million. Microsoft has a market capitalization of US\$271 billion and its net tangible assets are worth US\$36 billion.

In Australia, similar trends are emerging. AMP's (2005) Sustainable Alpha Team shows that 73 per cent of the value of the typical Australian company is made up of intangible assets. Buffini (2005) argues that the IFRS has done little to improve the situation, with the top 100 Australian organisations writing off \$7.5 billion in intangible assets in 2005. The key observation is that financial measures are incomplete[3].

Capital market players are increasingly asking question about the "gaps" between accounting and market value of the company. They look for information beyond the

P/L and balance sheets to assess company performance and share price value. AMP, one of Australia’s largest fund and wealth management companies, calls for a “New Era in Company Evaluation” (Figure 1). They are analysing different dimensions of companies, including how companies manage their human capital, customer and community relations, supply chain, brand values, etc. This analysis demands more information about intangible resources by capital market players and may have a “pull-effect” possibly resulting in more companies measuring and reporting on their intangible assets (AMP, 2005).

As suggested by Figure 1, it is possible to translate conceptually between financial models and elements of EBR. Research of capital market impacts of disclosure of EBR information has found that can disclosure can reduce information asymmetry and improve company valuation. Guo *et al.* (2005), for example, find that information about product development, R&D and the competitive environment, reduces information asymmetry and assists IPO pricing (Guo *et al.*, 2005). Thomas (2003) examines the impacts of intellectual capital reporting with financial analysts in the UK using an experimental design. She finds that an increase in disclosure of intellectual capital information leads to a tighter range of share price estimates and a reduction in beta, resulting in a lower cost of capital. A 2003 Deloitte survey of 388 fund managers and 80 investor relations officers finds that EBR information is increasingly important to investment decision making, with an anticipated surge in demand for such information over the next three years. Amber *et al.* (2001) study of the UK capital markets likewise calls for heightened levels of disclosure of EBR information, emphasising also the interest in disclosure of comparable and consistent data across organizations and time periods.

Yet, Figure 1 only tells the story of the risk premium and cost of capital. EBR may also influence cash flows. Investments in organisational capabilities may influence the firm’s innovation, productivity and relations to customers. And it is not hard to imagine that investments in innovation, in building organisational infrastructure, in developing the workforce and the capabilities of managers, and developing stronger

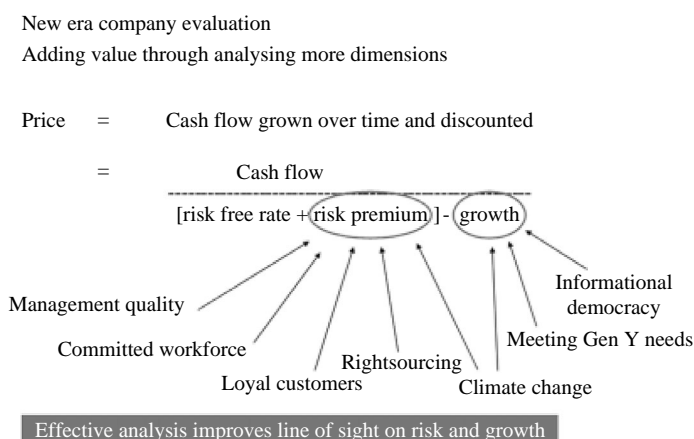


Figure 1.
Changing information
requirements of capital
markets

Source: AMP Presentation, Sydney, Australia, February 2007

relations with partners may transform into cash flows. Intangibles are, like other investments, assets.

This paper is organised as follows. Section 3 examines international trends and developments in EBR, highlighting the proliferation of new reporting frameworks and models. Section 4 provides several observations about EBR practices in general, while Section 5 identifies a number of international trends and issues. Also, this final section makes four recommendations on how to increase the uptake of EBR internationally.

3. International trends and developments

A growing number of reporting frameworks and measurement models have sought to address the changing information requirements of business executives and financial markets. Internationally, the last decade has seen the proliferation of a variety of reporting frameworks and models (Boedker *et al.*, 2007; Ricceri and Guthrie, 2008). It is beyond the scope of this paper to make a thorough analysis of these differences. However, it is noteworthy that the explosion of frameworks may create confusion about the meaning of EBR. It is, clearly, a phrase that relates more to the production of reporting than to the delineation of a particular object to be modelled in such reporting. A problem then is that EBR may not have similar purposes across frameworks and therefore, in the discussion of how they are similar and how they differ, attention to their different purposes, theories and assumptions about managers' work and about the roles of users of EBR may need to be specified.

Table II summarises briefly 16 prominent initiatives that aim to increase the disclosure of EBR information at the Global, National and Company level[4]. Notably, 15 of the 16 initiatives reviewed in Table II are voluntary (V), whilst only one is mandatory (M); a trend, which illustrates that, hitherto, the approach to EBR has been largely outside the realm of regulators.

Initiatives specifically related to intangible assets and intellectual capital reporting, include among others the following five, which are briefly reviewed.

The Danish guideline *Intellectual Capital Statements – The New Guideline* (Mouritsen *et al.*, 2003) was commissioned and published by the Danish Ministry of Science, Technology and Innovation. The guideline is the outcome of a multi-year project with over 100 Danish organisations volunteering to participate in the production of intellectual capital statements and report on the performance and composition of their intangible, knowledge resources.

The German Guideline *Intellectual Capital Statement – Made in Germany* was issued by the German Federal Ministry of Economics and Labour (FMEL) in 2004. The guideline acknowledges the growing importance of knowledge and innovation to economic growth and seeks to help organisations portray and evaluate intangible corporate values in a structured manner (FMEL, 2004, p. 7). It acknowledges that traditional controlling and management tools cannot provide information on whether an organisation's desired targets are being achieved or not.

The Austrian University Organisation and Studies Act came into effect for all state Universities in Austria on 1 January 2004. It mandates intellectual capital reporting for all universities as a basis for performance evaluation, and aims to restructure the educational and legal framework of universities to ensure public budgets are put on a new, more performance-oriented basis. The intellectual capital reports are used for:

Initiative	Requirement	Category
<i>Global level</i>		
IASB Management Commentary	In discussion	Broad based enhanced business reporting
OECD Multinational Enterprise	V	Corporate citizenship and sustainability
United Nations Global Compact	V	Corporate citizenship and sustainability
United Nations Global Reporting Initiative	V	Corporate citizenship and sustainability
<i>National level</i>		
Australian parliamentary inquiry into corporate responsibility and triple bottom line reporting	V	Triple bottom line and corporate citizenship and sustainability
Australian guiding principles on extended performance management (SKE)	In draft format	Broad based enhanced business reporting
Austrian Universities Organisations and Studies Act	M	Intellectual capital
Danish Guideline on Intellectual Capital Reporting (MSIT)	V	Intellectual capital
German Guideline on Intellectual Capital Statements (FMEL)	V	Intellectual capital
Japanese Intellectual Based Management (METI)	V	Intellectual capital
MERITUM Guideline (EU Commission)	V	Intellectual capital
UK Operating and Financial Review (ASB)	V	Broad based enhanced business reporting
US Enhanced Business Reporting Consortium	V	Broad based enhanced business reporting
<i>Company level</i>		
Balanced scorecard (Kaplan and Norton)	V	Intellectual capital
Intangible asset monitor (Sveiby)	V	Intellectual capital
ValueReporting™ (PwC)	V	Broad based enhanced business reporting

Table II.
International initiatives
in enhanced business
reporting

- external reporting purposes to publicly account for the use of tax money, publish the university's performance, and to inform budgetary reimbursement and performance-oriented budget allocation from the Federal Ministry and private institutions; and
- internal management and control purposes to assist in performance evaluation enabling more efficient use of resources, and improved management decision making and forecasting (Ricceri, 2008).

The Japanese *Guideline for Disclosure of Intellectual Assets Based Management* was released by the Ministry of Economy, Trade and Industry (METI, 2005) in October. The Guideline aims to assist corporations in preparing intellectual assets reports. The guideline advocates sustainability and stakeholder engagement, and aims to help managers develop a deeper understanding of the role intellectual assets plays in organisational value creation.

Finally, the Australian Guiding Principles on Extended Performance Management – A Guide to Better Managing, Measuring and Reporting Knowledge Intensive Organisational Resources was issued in draft format by the Society for Knowledge Economics (SKE) (Boedker, 2005). The guiding principles encourages organisations to

adopt a more strategic and inclusive approach to managing, measuring and reporting intangible resources, be they human, structural or relational. The guiding principles since 2006 inform the Australasian Reporting Award on Knowledge Capital, to which a growing number of Australian organisations have been submitting reports.

4. Observations and commentary

Several observations can be made about the initiatives reviewed in Table II and EBR practices more broadly (Ricceri, 2008; Boedker *et al.*, 2007; Unerman *et al.*, 2007).

The first observation is that the last decade has witnessed a growing number of initiatives aimed at measuring and reporting intangibles (Denmark, Austria, Finland, Japan, etc). This is a testimony that more and more nations are acknowledging the importance of addressing the shortfalls of traditional financial reporting (Boedker *et al.*, 2007; Ricceri and Guthrie, 2008).

A second observation is that existing initiatives are developed in isolation. They do not specify how they build on each other and they are silent on the choices they have made to overcome some assumed – but rarely documented – problems with other frameworks. The diversity of frameworks mean that individual frameworks are closely attached to the constituencies involved in their production and this may help to increase experimentation and implementation. On the other hand, such diversity can also result in perceived fragmentation and adversely impact the uptake by information users, specifically those in the capital markets.

Austrian research (Schaffhauser-Linzatti, 2004) on intellectual capital reporting found that diversity reduces the general understandability and interpretability of these statements. Specifically, this research argues that information usage is made difficult by missing uniformity of terminology and definitions. Also the lack of uniformity in approaches/frameworks for measurement and reporting create confusion and barriers to “understandability” as does an absence of uniformity of use, that is, internal versus external application and relevance. Ease of understanding is an important issue, but a better question to raise is to what extent the need to be easily understood should be a factor in the development of the EBR frameworks; rather is the question to what extent is it a matter of re-training users and producers to understand the logic of EBR?

The Institute of Chartered Accountants in England and Wales (Amber *et al.*, 2001)[5] similarly studied non-financial reporting in capital markets and found that inconsistent reporting across years and companies limit the use of EBR information among analysts. They link this to transparency and competitive intelligence issues, and conclude that inconsistency makes it difficult for information users to absorb, compare and analyse EBR information.

Furthermore, it appears that the many existing initiatives shown in Table II lack harmonisation at the international level, not solely within national states. The European nations are the most advanced and forward-thinking in measuring and reporting on their intangible resources, with the USA and other countries lagging behind in terms of the proliferation and uptake of reporting practices. Yet, the vast diversity that exists within Europe and internationally, may adversely affect broader uptake. This diversity is, as noted, a problem but it is important to analyse in more detail the costs and benefits of diversity.

A third observation is that reporting on intangibles, and EBR information more broadly, remains largely voluntary. The UK Operating and Financial Review was

originally introduced as a mandatory practice for all UK public listed companies but was, after a short time, made voluntary (UK Accounting Standards Board, 2005). The large-scale Danish project on intellectual capital reporting likewise had limited impact on reporting requirements in Denmark, or more broadly in the European Union, resulting only in a one line addition in local regulation. The International Accounting Standards Board is likewise opting for a voluntary approach to include Management Commentary in financial reports in 2007.

In summary, the key points to consider when analysing developments in EBR are, first, that there is growing interest in EBR information among business executives and financial markets whose information requirements are changing, reflecting the transition from an industrial society to a knowledge intensive, globalised economy. Second, numerous initiatives have sought to address the changing information requirements of business and financial markets, and internationally, the last decade has seen a proliferation of many different reporting and measurement frameworks and models. Third, whilst EBR proliferates, the many frameworks developed offer vast diversity in terminologies and reporting practices. Whilst, on the one hand, such diversity can increase “experimentation” and the uptake of EBR within business, on the other hand, it can also lead to fragmentation and adversely affect information usage, specifically in capital markets. A lack of harmonisation continues to be a barrier to broader uptake and practice.

5. Possible policy directions

Given the trends identified above, the paper now outlines several propositions for how to further EBR and its uptake. They may be seen as recommendations to practitioners, but in the context of research they may be seen as areas for further investigation.

5.1 International harmonisation

The diversity in reporting practice indicates a need for harmonisation at an international level. Harmonisation may involve the creation of international communities of practice, which bring together practitioners, policy makers and thought leaders from around the world. For instance, the World Intellectual Capital Initiative by the OECD and others provides one example of an appropriate vehicle for facilitating debates, mediating knowledge and practice, and improving international collaborations and harmonisation. It may also involve the commissioning of larger scale projects where businesses from different countries empirically test one reporting model over a longer time period (for example, the Danish Intellectual Capital project where over 100 companies worked together for five years). International collaborations of this kind can aid harmonisation and provide opportunities to bring reporting practices “closer together”. Finally, harmonisation could incorporate greater involvement from, and collaboration between, standard setters, such as the International Accounting Standards Board, the US SEC, the European, Australian and Japanese ministries and policy makers, etc. Such forums may not be able to develop a coherent set of principles for reporting on EBR but they will be able to develop experimentation under the premise that others’ frameworks have been contemplated. They may facilitate a sharing not only of techniques of EBR reporting but also facilitate dialogue about the purposes and usefulness of EBR, just as they may develop “critical cases” from around the world.

5.2 Accounting technology

The vast diversity in measurement and reporting models also suggests the need for consolidation and simplification of EBR techniques. Flexible accounting technologies, such as XBRL, provide an opportunity to do so. XBRL is a flexible technology, which introduces consistency in reporting format and content, yet also allows enough flexibility to accommodate diversity. It may benefit business by simplifying and streamlining reporting practices. A common technology will also help improve information comparability and consistency, and thus assist information users (specifically those in capital markets) better absorb, analyse and incorporate EBR information in their investment decision-making process. Importantly, accounting technology is a key driver of the interest in EBR because otherwise it stays as a “good idea” and good ideas are rarely enough to secure circulation. The media of circulation have also to be in place and accounting technology is potent here.

5.3 Practical experimentation

While experimentation with EBR has been on the increase in Europe, Japan and Australia, limited practical insights have been derived from US companies. In this regard, it is refreshing to see initiatives such as the EBR consortium gain traction and strength in the USA. Indeed, the EBRC may be a suitable body for increasing practical experimentation with American businesses. EBRC could, for example, host collaborative projects with US businesses to test the practical use and effects of new accounting technologies, such as XBRL. Diverse stakeholders (such as US financial analysts, chartered accountants, policy makers and researchers) can be brought together to collectively examine what works in practice and also to develop credible criteria for what good accounting of intangibles will look like (ie criteria such as reliability, objectivity, identifiable). Collaborative projects can also provide more empirical insights into the cost and benefits of EBR to business and others, and bring forth more evidence to support investments into EBR and the development and measurement of intangibles as strategic resources. Again, experimentation at one level may serve to develop practical solutions. But more importantly it also teaches participants what the idea – EBR – is and can be.

5.4 Education

Greater visibility into EBR “what it is” and “how to do it” is required to increase practical uptake and the broader knowledge base and awareness of EBR in the community. Inclusion of curriculum on EBR and intangibles in management education programs (ie MBAs, financial analysis and chartered accounts) can help improve awareness and practice. Curriculum can focus on business innovation more broadly and also, more specifically, on how to measure, manage and report on business performance in a knowledge-based economy. When it takes years to teach a person to become fluent in the financial language, it is not realistic to expect the language of EBR to be understood immediately?

5.5 Research

The suggestion that harmonisation is preferable is still a hypothesis. There is therefore a need for research to analyse what harmonisation entails. In particular, inquiry into how the diverse frameworks differ theoretically and empirically is needed. The key questions are:

- Are the differences between frameworks cosmetic or substantial?
- How do the frameworks consider and define the referent of their representation? What is actually measured?
- How do the measurements in the frameworks suggest justifying decisions about investment in knowledge and innovation?
- How would quality criteria of EBR measurement look? Are they similar to those favoured by (e.g. FASB)?

Notes

1. For more information about the Pozen Committee, see www.sec.gov/about/offices/oca/acifr.shtml
 2. See also the Deloitte (2003) survey of 388 fund managers and 80 investor relations officers, which found that EBR information is also increasingly important to investment decision making, with an anticipated surge in demand for such information over the next three years.
 3. A vast array of studies makes this observation (see for example the Australian Department of Industry, Science and Resources (DISR, 2001), *Invisible Value: The Case for Measuring and Reporting Intellectual Capital*, Canberra, see also Mouritsen *et al.* (2003). A lack of reporting intangibles can result in understated earnings, as investments are expenses not amortised. It can also result in an understatement of the book value of equity. Also, an increase in the cost of capital can occur as can lower share price due to increase in WACC. Finally, a lack of intangibles can also result in information inequality and an underinvestment in the drivers of value creation and ineffective resource allocation.
 4. The last column in Table I classifies the initiatives into four different categories, as follows:
 - (1) Triple bottom line (social, environmental and economic impact) reports consider the external impacts of organisational activity, including, for example, the contribution to the organisation to the national economy, the community and the environment.
 - (2) Corporate citizenship and sustainability is concerned with stakeholder interests, human rights issues, labour relations and environmental impacts. Focus is largely on multinational enterprises and on minimizing the adverse effects of globalization and ensuring the sustainability of the “global village”.
 - (3) Intellectual capital reports record information about the composition and performance of organisational intangible resources, such as relational, human and structural capital. They are primarily concerned with how such knowledge resources are managed, developed and utilised in the pursuit of a company’s strategic objectives.
 - (4) Broad based enhanced business reporting embraces elements of both intellectual capital (including relational, structural and human capital), the triple bottom line (including social, environmental and economic impact reporting), and stakeholder interests and sustainability. It is used as an overarching term used to embrace the above mentioned categories.
- For a detailed review of the sixteen initiatives, see Boedker *et al.* (2007).
5. This study was based on content analysis of the Annual Reports of 125 FTSE companies, interviews with 47 Chairpersons/Senior Executives, a survey sent to 1,568 financial analysts (18.5 per cent response), and interviews with financial analysts.

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