Chapter 15
The Limitations of Financial Reporting on Innovation and Its Value-Relevance for the Investor's Decision-Making Process

Francisco Leote
Polytechnic Institute of Setubal, Portugal

Ana Damião
Polytechnic Institute of Setubal, Portugal

ABSTRACT

This chapter aims to present some limitations of financial reporting on innovation with an impact on the investor's decision-making process. In order to do so, the authors show how accounting recognizes and measures innovation factors: the intangibles. Based on the literature, the authors discuss how the value relevance of financial reporting on innovation is conditioned by non-financial factors. The impacts of the adoption of IFRSs, the effect of the industry sectors and the effect of the individual characteristics of the different countries on the value relevance of the intangible assets are analyzed. The literature suggests a decrease in the value relevance of financial statements due to the manner in which intangibles are recognized and measured in accounting. However, financial reporting on innovation is value relevant to the investor's decision-making and is conditioned by non-financial factors. Value relevance differs among different industry sectors, between different countries and is conditioned by the accounting systems used in the preparation of the financial information.

INTRODUCTION

Innovation is considered a key factor in creating value, differentiation and competitiveness of companies. Intangible resources such as R&D, patents, copyrights, market share, trademarks, customer loyalty and computer software are the main value creators for shareholders in the knowledge economy, whose values are often not reflected in corporate financial reporting.

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The economic value of intangible items depends on a set of factors such as the market, industry, society and technology. Their value is measured by the economic benefits arising from their use, sale or licensing.

Companies with few physical resources worth "millions" because their intangibles are their key differentiating and competitive advantage factors. Examples of this are Pfizer's patents and the Coca-Cola brand, which enable the business owners to obtain substantial returns and obtain earnings over a long period of time (Lev, 2005). Companies such as McDonalds, Nike or Visa, whose company's net worth in no way correspond to their market leadership, but whose brand names attract customers for the values that the trademarks render. These facts lead companies to show significant discrepancies between their market value (the price buyers and sellers are willing to trade company shares) and their book value (the equity value disclosed on the company's statement of financial position). This is largely due to the difficulty of accounting to respond to the current needs of the economy, particularly on the recognition and measurement of innovation factors: the intangibles.

Accounting theory has restricted the classification of intangible assets to items that meet the criteria of identifiability, control and expected future economic benefits. The criterion of identifiability consists in the ability of the intangible asset being separated or divided from the entity and sold, transferred, licensed, rented or exchanged. The control criterion relates to whether the entity has the power to obtain the future economic benefits that flow from the underlying resource and to restrict the access of others to those benefits. The third criterion is the ability of the intangible asset to generate future economic benefits that may include revenue from the sale of products or services, cost savings, or other benefits resulting from its use by the entity. Intangibles that do not meet any of these requirements are immediately recognized as expenses.

As to its provenance, the intangible asset may be acquired separately, be generated internally, or even acquired in a business combination. Thus, it is possible to classify intangible assets as (Dahmash, Durand, & Watson, 2009):

- **Identifiable Intangible Assets:** In this case, the assets are recognized individually on the balance sheet. This type of intangible assets may still be sub-classified into acquired intangible assets such as R&D projects, industrial property (trademarks, patents, licenses), among others that have been acquired separately or in a business combination, or internally generated intangible assets - such as R&D projects and software that are developed within the entity.
- **Non-Identifiable Intangible Assets:** The most common example of this type of intangible is goodwill. Goodwill[1] is defined as part of the company's market value that is not reflected by its identifiable assets and liabilities. This concept corresponds to future economic benefits arising from assets that are not individually identified and separately recognized. These include the value of a company's brand name, design and implementation of new processes or systems, knowledge capital, customer relationships, among others. Due to the particular aspects of this type of resources, goodwill can only be recognized as an intangible asset on the financial statements when acquired in a business combination.

The lack of recognition of intangibles on the balance sheet or their understatement lead investors to value companies for much more than their net worth and this, consequently, widens the gap between companies' accounting and market values. This is because investors acknowledge the ability of intangibles to increase cash flow, an aspect that is not considered in the book value.

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