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Innovation in financial statements – evolution and trends

Abstract. *This paper is an attempt at predicting the direction in the evolution of financial reporting in the context of its potential as a source of information on innovative processes undertaken by companies as part of their economic operation. The article uses literature studies, an analysis of the regulation of accounting law, observations of business practice, and conclusions arising from the research presented in earlier publications of the author.*

Keywords: *innovation, financial statements, integrated reporting, standards of accounting*

Introduction

Innovation has always been at the centre of human endeavours. Nowadays, its position and significance reached new levels. To a large extent, innovation stimulated the development of competitive organisations and reorganised many aspects of their operation. Innovation was also a strong stimulus for changes in business practice, which were further reflected in legislative regulations. On the one hand, this elevated status of innovation can be attributed to the fact that innovation is an inherent determinant of operational development in many companies (particularly the high-tech segment). On the other hand, the outcome of innovation is a factor that defies prediction. Activities undertaken in relation to innovative processes are

burdened with considerable risk, uncertainty, and require steep financial outlay. As a result, innovative processes should be subject to continuous control at every stage. Furthermore, policies of innovation should be disclosed and presented to company stakeholders. To meet this requirement, companies need suitable sources of information.

Changes in accounting standards have been introduced to define these additional sources of information, as instruments for monitoring the course of innovative processes and for the evaluation of its effects. Information on methods and effects of innovative activities undertaken by companies gained the interest of both internal and external stakeholders, resulting in changes to financial reporting standards. Financial reporting has evolved into integrated reporting, following the inclusion of additional information presented in separate reports. Recently, evidence for opposite trends can be observed. The 'lean' approach, typically associated with management sciences, has also found its way into accounting science. It advocates careful selection of information that is relevant and indispensable for decision-making purposes by means of limiting the volume of obligatory reports. In this context, and in view of the specificity of innovative processes, reasonable doubts may be raised with regard to the scope of information disclosure referencing the innovative activities. Is it relevant and complete? How to present it? Does it meet the stakeholders' expectations?

This paper is an attempt at predicting the direction in the evolution of financial reporting in the context of its potential as source of information on innovative processes undertaken by companies as part of their economic operation. The deliberations are based on literature studies, analyses of balance sheet regulations, empirical observation and results of research studies presented in earlier publications by this author. Article is a theoretical considerations.

1. Financial report as a source of information on innovative processes

The nature of reporting is to identify, measure (in financial terms) and present to the public all the complex elements of economic operation, including the scope and scale of innovative processes undertaken by the company. The task of company accounting system is to provide clear, relevant and, above all, reliable, verifiable and non-biased information on the company's financial position, assets and economic operations (also those of innovative character). At the same time, taking into account the principal roles of accounting – information, control, management, and planning – the results, in the form of generated information, should be disclosed in financial statements. To this effect, company information systems are

adjusted to the needs and expectations of the decision-makers [Piotrowska 2013: 420]. The need for disclosing information on adopted business models and innovative activities has initiated changes in the financial reporting standards, with the objective of increasing the informative potential of obligatory statements.

Information on the realisation of individual stages of innovative processes, the scale of operational involvement (time, manpower), their measurable effects (both financial and non-financial), the scale and classification of the associated expenditure and its effectiveness in relation to the present or expected results can also take non-financial form. Not all the information in this context can be readily generated by the accounting system, but is nonetheless of great importance and should be taken into account in decision-making processes. This is why financial information from accounting systems should be supplemented by non-financial information generated by other evidencing systems.

A traditional financial statement provides information only with respect to research and development activities as sources of innovation. In accordance with balance sheet regulations, the effects of R&D activities are part of the entity's intellectual resources (experience, knowledge, potential, skills, and competences) and, as a non-material asset, should be reflected on company balance sheet.[1] Its value (the cost of production) should be represented incrementally for each relevant reporting period. On the other hand, the cost of R&D burdens the financial result of the period in which it was incurred. However, financial reporting standards do not define the scope of obligatory disclosure in this respect, nor provide separate items for its presentation. In effect, information users cannot access information on this type of cost, unless the entity itself chooses to disclose them, for example in the notes to the financial statement.

Presentation of innovation in financial statement is determined by their identification and cost valuation. The effect of this process, identified as a balance sheet item or result item (resource or process) and properly valued, is presented as part of the traditional financial statement, but only if the company is able to identify and quantify the economic category associated with the innovation effects (balance sheet) or processes (profit and loss account). It can also be presented descriptively and formally as part of the notes to the financial statement. It must be noted that financial reporting information is typically adjusted to fit the needs of external users, since internal stakeholders have immediate access to the company accounting system as a source of supplementary reports and detailed accounts required for management purposes.

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[1] *Międzynarodowe Standardy Sprawozdawczości Finansowej 2011*, International Accounting Standards Committe, Londyn 2011, translated and published by the Association of Accountants in Poland; Ustawa z dnia 29 września 1994 r. o rachunkowości, Dz.U. nr 121, poz. 591 z późn. zm.

Therefore, since the course of individual stages of innovation processes and their results are not properly reflected in traditional financial statements, the need arose to initiate changes and trends in the evolution of financial reporting to meet this requirement [Jędrzejka 2012: 313-325; Krasnodomska 2012a: 68-86; Szczepankiewicz 2014: 135-148].

2. Evolution in the presentation of innovation in financial statements

Financial reporting is a systematised (properly selected, grouped and aggregated) set of synthetic information of financial nature, sourced mainly from the accounting or other evidencing systems, relating to past and present financial condition, asset structure and financial result, and applicable for the purpose of making informed decisions for the future [Samelak 2013: 79]. The scope and the quality of reported information is defined in the context of requirements and needs of information users. Changes in the needs and requirements determine the character of changes in the scope and methods of presentation, but not the quality of information disclosed for the purpose. This is why financial statements must fulfil the requirements of balance sheet law, standards of accounting and the adopted accounting policies.

The need for information on innovative processes and company policy of innovation has been reflected in changes to the financial reporting. Statement users, by defining the scope of information required for decision-making, specified the set of obligatory disclosures, their content and their presentation. This had the effect of setting trends for the reformulation of financial statements and their adjustment to stakeholders' expectations. The formal scope of disclosure, as specified in reporting regulations, has been supplemented by non-financial information as part of companies' information policy within the broader context of corporate governance.

The appreciation for the role of innovative activities largely determined the information requirements in this area. Modern trends related to changes in financial reporting, introduced in reaction to the information needs of statement users voiced with respect to innovative activities, are presented in Table 1.

It must be noted that information on innovations undertaken by companies (their forms, quality, application results) has become a major area of interest for the users of external financial reports. This was reflected in changes to formal balance sheet regulations. On the other hand, the need for monitoring the course of innovative activities, evaluating their effects and assessing their impact on

Table 1. Trends in the development of innovation content and its presentation in financial statements

No.	Directions in the evolution of modern financial reporting	Disclosures and methods for presentation of information on innovative activities – the scope
1.	Increasing clarity and transparency of information disclosed in financial statements.	Subjectivism in the evaluation of innovations makes it difficult to maintain the neutrality in reporting.
2.	Broadening the objective scope of financial statements.	Supplementing information on innovative activities (as part of the management report or as a report on intellectual capital).
3.	Measuring risk and disclosing its effects in financial statements.	Disclosure of risk management information (risk measurement, safety measures, internal control) on the results of innovative processes.
4.	Measuring the entity's market value based on disclosed information.	Measurement and valuation of intellectual capital as an effect of innovative activities.
5.	Disclosing of information from management accounting.	Disclosure of information on policy of innovation on both operational and strategic level within the adopted business model.
6.	Adjusting the content of financial statement to suit the requirements of its users.	Disclosure of information on the present innovation processes, adjusted to the needs of the stakeholders.
7.	Standardisation and harmonisation of financial reporting.	Unification of methods for identification, valuation and presentation of information on innovative activities.
8.	Attempts at changing the present model of reporting or defining a new model.	Supplementing the traditional financial statement with reports on intellectual capital, including separate items for the presentation of innovative activities.
9.	Changing the form of financial statements – based on application of new IT and digital technologies.	The use of integrated IT systems to support the information process in its innovative aspects (promptness, clarity, own and easily accessible knowledge base).
10.	The strife to formulate unified standards for preparation and presentation of financial statements.	A postulate for introducing an integrated report in the conceptual framework for international reporting standards.
11.	Transforming financial statements into business reports.	Opening the prospect for disclosing information on innovation policies and business models.
12.	Promoting ethical standards and corporate social responsibility principles.	Disclosure of accounting policies with respect to identification, valuation and presentation of information on innovative processes, in line with the principles of accuracy and continuity, with particular attention to the principles of professional ethics.

S o u r c e: own research, based on Samelak 2013: 113.

company profits has brought changes within the area of management accounting. The supplemental set of information on company policies of innovation, as generated by various evidencing and information systems has led to the initiation of evolutionary changes of traditional financial reporting into the so-called integrated reporting. Since disclosure of innovation in traditional financial statement format proved impossible (despite many attempts), experts postulated to utilise separate information reports within the broader framework of integrated reporting.

3. The role of integrated reporting as a source of information

Presentation of information is directly related to its disclosure and publication. The scope of disclosure and the use of specific presentation methods are in direct association with the adopted accounting policy, the pending regulations, and the knowledge/information requirements of its users. Disclosure of information beyond the scope of financial statement format plays an increasingly important role on global markets. Users are particularly interested in those asset items which directly impact company competitive advantage or attract potential investors, but the accounting system does not perceive this type of information in terms of identifiable and measurable resources fit for presentation, due to its non-financial character. It must also be emphasised that no single reporting document can be expected to reconcile all the various information needs of assorted external users. As a result, the information demands from various decision-makers largely determined the need for disclosure of non-financial information, presented in separate reports attached to statements within the broad framework of integrated reporting.

The principles and the scope of financial disclosures are regulated by formal legislative regulations, while the scope of non-financial disclosures is a product of the policy of information adopted by the entity itself. The structure of an annual report (integrated) for public listed companies is defined in formal regulations, but for other types of companies, the format of disclosure is a product of common law. The annual integrated report should contain: a letter to the stakeholders, a financial statement, a management report, separate reports on economic risk, intellectual capital and environmental impact, and a report from audits of reports contained in the annual integrated report [Samelak 2013: 118; Krasnodomska 2012b: 101-110]. The integrated report preserves the dominant role of financial statements and management reports as sources of primary and supplemental financial information for decision-making purposes, but it also retains the potential to present a true image of economic activities undertaken by the company and of

their impact on asset position, also with respect to the realisation of the company's policy of innovation.

A management report for a company involved in innovative activities should provide detailed information on the most significant R&D objectives (under way or completed), including their purpose, course of realisation, risks, results (such as patents, new or modernised products, new technologies), implementation effects, delegated manpower, financing sources and the anticipated benefits resulting from their implementation [Fedak 2007]. It must be noted that the principal idea is to present a general overview of company activities in the R&D area and their advances, as opposed to a detailed account of individual tasks and processes (which are typically confidential).

The end result of innovative activities may be disclosed as part of company resources. Based on proper identification and quantification, it may be presented in a financial statement. On the other hand, the sum of generated knowledge, skills and competences (as part of company potential that may impact its value) may be presented in additional reports attached to the annual report within the framework of integrated reporting. The considerable uncertainties and risks associated with innovative activities make it important to properly identify and measure the risk level as well as define the acceptable risk level. Information on methods used in risk identification and management is of great value to external stakeholders, therefore it needs to be disclosed in the management report or presented in a separate risk report.

To sum up, it must be stressed that financial statements (in its traditional form) should be supplemented by management reports, intellectual capital reports and reports of risks involved in innovative processes (often unpredictable and uncertain, but always burdened with steep outlays). The scope of information presented in supplementary reports is not regulated by any legislative provisions or formats of presentation. This raises reasonable doubts as to their presentation, structure and level of detail. Some experts believe that the scope of this type of information should be defined in formal regulations, others suggest to determine it by concentrating on the standards and quality of accounting. The search for solutions in fair and accurate presentation of methods and effects of innovative processes is ongoing.

4. Reporting of innovative activities – postulated changes

Further direction of changes in reporting innovative activities involve modification of the existing formats of reports, to make them more adjusted to the information requirements of the users. At the same time, there is some evidence of the

opposite trend, postulating a considerable reduction in the scope of disclosures, but with more emphasis put on the quality of such information. The 'lean' concept, adopted with some success in both theory and practice of management, has also made its appearance in the context of reporting. The previous approach, based on excessive use of numerous information sources and multiple reports, has proven ineffective. Reduction of disclosure scope seems necessary, but this again raises reasonable doubts. How to modify the existing sources to reduce the amount of information while improving its informative value? Do we need to devise other reporting formats or should we attempt to modify the existing forms? Or should we eliminate some of the reports as obsolete for decision-making purposes?

One of the popular postulates is the concept of knowledge-based balance sheet presenting competence assets. Niemczyk suggests to include innovative (R&D) projects in the calculated value of their associated costs. This would take the form of supplementing an additional item on the balance sheet, offset by the company intellectual capital [Niemczyk 2013: 177]. The effects of innovative activities come in the form of knowledge, skills and competences, which constitute a company resource. The lack of explicit correlation between the volume of knowledge and the resulting profits for the company makes it difficult to accurately identify and value knowledge as a resource, not to mention its presentation in balance sheet format. The postulate of using competence assets as part of the knowledge-based balance sheet and presenting them in terms of the associated cost offset by the intellectual capital seems interesting, but it does not depart from the earlier attempts at identifying and measuring intellectual capital for balance sheet purposes. These concepts proved ineffective and resulted in the introduction of a separate type of reports within the framework of integrated reporting.

The very concept of disclosing the cost of competence assets and entering it as part of non-balance evidencing based on competence reports, as well as measuring and presenting competence assets in terms of the associated costs seems acceptable. However, the idea of presenting it as an equivalent of intellectual capital (particularly across the consecutive reporting periods) with no method to assess its fair value may raise doubts as to the quality of the resulting reporting information. Since the utility of such information, the reliability of calculations, and the spread of balance sheet representation over multiple reporting periods are being questioned, further research effort is needed to ensure (without a shadow of a doubt) that the approach based on identification and valuation of competence assets can be reliably applied in various settings. Ideally, this would help formulate a universal model for the identification and valuation of competences for the purpose of disclosure and presentation as part of financial reporting. The recent postulates for reactivation of the prudence principle (adjusted to the requirements of the present model of financial reporting) might be of some help in this effort. If we can anchor the identification, valuation and presentation of data in the context of prudence

principle, the effects will more accurately reflect the 'true and fair' postulate, to the benefit of the users of reporting information [Gos, Hońko 2015: 39].

To sum up, it may be observed that the scope of disclosure is defined by: formal regulations defining the scope of information to be disclosed obligatorily by companies in line with the adopted accounting policy; by the demand for (or interest in) specific information for decision-making purposes (particularly in the context of the steady increase of economic and information awareness on the part of potential investors, as one of the results of rapid economic development); and by the company itself, since it is for the company to decide on the scope of information to be disclosed without breaching the legislative regulations and without risking the loss of confidential information. This concern is particularly evident in relation to innovative activities developed as a result of research and development efforts.

Conclusions

Based on the research results (literature studies, analyses of balance sheet regulations and empirical studies), the author was able to formulate the following conclusions:

1. Companies willing to preserve their competitive advantage on modern global markets must undertake innovative activities and put a strong focus on research and development.
2. Innovations, as any other process, should be subject to monitoring and control, their results should be evaluated, and the related information should be presented to external decision-makers.
3. Users' demand for non-financial information, including information on innovative activities, resulted in the pressure to adjust the present format of financial reporting and to transform it into integrated reporting.
4. Within the framework of integrated reporting, financial statements retain the status of the main source of information on the results of innovative processes, but they should be supplemented by additional information provided in management reports, reports of the associated risks, and reports on intellectual capital,
5. More and more postulates are formulated in favour of transforming the traditional balance sheet approach into knowledge-based balance sheet formula to better suit the needs of company stakeholders – this stage of the evolution, however, requires further studies.
6. The opposite trend involves postulates based on the application of the 'lean' concept in financial reporting, i.e. limiting the quantity of information sets and sources, while retaining or improving its quality; this approach may be

facilitated by the reinterpretation of the prudency principle within the accounting standards framework.

To sum up, it may be worth stressing that proper management of innovative processes requires direct access to information on the effects of the policy of innovation and its disclosure to external decision-makers. For external stakeholders, the financial statement remains the most important source of financial information, while non-financial disclosures are typically presented in reports supplemented to the statement within the integrated reporting formula. The complexity of this process largely determines the need for accurate recognition of the objectives (forms of innovation) and stages of realisation, to ensure proper identification, valuation and presentation of the respective information for the purpose of integrated reporting. The present changes and trends in financial reporting seem to favour further reduction of information quantity while retaining or improving its quality. This approach may significantly improve the utility and versatility of disclosures, particularly if reinforced through the 'reactivation' of the prudency principle.

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Prezentacja innowacji w sprawozdawczości finansowej – ewolucja i kierunki zmian

Streszczenie. *Celem artykułu jest próba udzielenia odpowiedzi na pytanie, w jakim kierunku ewoluuje sprawozdawczość finansowa jako źródło informacji o realizowanych w przedsiębiorstwie innowacjach i jakie mogą być dalsze kierunki tych zmian. W artykule wykorzystano analizę literatury przedmiotu, regulacji prawa bilansowego i obserwacje praktyki gospodarczej oraz wnioski wynikające z prowadzonych badań prezentowane we wcześniejszych publikacjach autorki.*

Słowa kluczowe: *innowacje, sprawozdanie finansowe, sprawozdawczość zintegrowana, informacja sprawozdawcza*