

A Theoretical Framework for Intellectual Capital Disclosure

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Abstract

Intangible have come to play an important role in the process of value creation especially in knowledge intensive firms. Intellectual capital (IC) and corporate financial performance also is seen to be associated. The nature and amount of IC disclosure is found to be low in many emerging economies including India. The reason is normally attributed to no regulatory compulsion to measure & disclose IC and also general lack of awareness among the firms about the tools to measure and report IC, the financial returns associated with it and skills required to manage and create knowledge within the firm. This article attempts to provide an overview of the concept of IC, the need for IC disclosure, and the various methods that the firm can adopt to disclose intellectual capital to its external stakeholders and also come up with strong suggestion for knowledge intensive firms in India to start the process of IC disclosure.

Keywords:

Intellectual capital, Financial performance, Theories etc.

Introduction

The share of intangibles in the total assets of firm has been increasing in the recent past especially in the knowledge intensive firms. Many research works have proved that value of the firm is also dependent on its Intellectual Capital (IC). With the growing importance of IC, its impact on the firm's financial performance also became a crucial factor of analysis, as many firms were concerned about the return on investment made by them on measuring and reporting IC. It was found that overall there is relationship between extent of Intellectual capital disclosure and corporate financial performance.

In spite of research evidence demonstrating the impact of Intellectual capital on value creation, it is observed that IC measurement and disclosure has become popular among few firms who measure and report IC even in developed countries, also there is a general lack of awareness on the types, classification, measurement tools and benefits of IC disclosure in many emerging economies, which is the main factor that results in almost negligible or no disclosure in these countries.

This article attempts to provide an overview of the concept of IC, the need for IC disclosure, and the various methods that the firm can adopt to disclose intellectual capital to its external stakeholders.

Concept of Intellectual Capital

The term Intellectual Capital (IC) gained prominence in the last two decades

and mainly stood to represent the intangibles within the firm, since then it has been defined and classified in several different ways. There is no generally accepted definition of Intellectual capital; broadly IC as any creation which emerges from the human mind. Edvinsson defined it as Knowledge that can be converted to value (Edvinsson, 1997).

However, Karl-Erik Sveiby first proposed a classification for Intellectual Capital into three broad areas of intangibles namely Human capital, Structural capital and Customer capital (Sveiby, 1989); a classification that was later modified and extended by replacing customer capital by relational capital by Dr. Nick Bontis (Bontis, 1991).

Human capital refers to the skills, competencies and knowledge of the employees within the organization that enable creation of more value for the firm. Relational capital is what customers and suppliers of the organization bring in, networking, contracts and agreements are usually built on this. The Structural/organizational capital includes the knowledge and information infrastructure and intellectual property of the firm that supports the human capital to function in furthering the vision laid down by the top-management.

The classification offered by the International Federation of Accountants (IFAC) is given below in Table 1

Table 1: Classification of Intellectual Capital

<p>Human Capital</p> <p>Know-how Education Vocational qualification Work related knowledge Occupational assessments Work related competencies Entrepreneurial élan, innovativeness, pro-active and reactive abilities, changeability's</p>	<p>Relational (Customer) Capital</p> <p>Brands Customers Customer loyalty Company names Backlog orders Distribution channels Business collaborations Licensing agreements Favourable contracts Franchising agreements</p>
<p>Organizational (Structural) Capital</p> <p>Intellectual Property</p> <p>Patents Copyrights Design rights Trade secrets Trademarks Service marks</p>	<p>Infrastructure assets</p> <p>Management philosophy Corporate culture Management processes Information systems Networking systems Financial relations</p>

Source: IFAC (1998)

IC Disclosure: Meaning and Methods

IC disclosure or reporting is an voluntary exercise by firms; the annual financial reports of the firm which are considered as a standard source of information regarding the financial performance of firms normally do not include details on intangible or intellectual capital of the firm; many firms prefer to provide the IC performance as an appendix along with the financial reporting and some of them publish them as a separate statements/reports. It is also observed that there exists lack of continuity in IC reporting.

Intellectual Capital Disclosure is defined by Abeyesekera and Guthrie (2002) as a report intended to meet the information needs common to users who are unable to command the preparation of reports about Intellectual Capital tailored so as to satisfy specifically all of their information needs (Gan et al.2008). Intellectual Capital Disclosure represents an approach that can be used to measure intangible assets and describe the results of a company's knowledge – based activities (Ismail, 2008, Neysi and *et al*, 2012)

It is pertinent to mention here that though there has been a lot of emphasis on IC, there are no standard methods of disclosure of IC as on date and it is voluntary and unregulated practice in nature across the globe. As the concept started gaining prominence especially in knowledge intensive firms, disclosure of IC was considered useful by management of several large firms. The result was that models, nature and extent of disclosure varied vastly between different firms, between industries and also between countries.

The research on relationship between the variables of the firm and the extent of disclosure also concludes that size, management composition, leverage and type of ownership are associated with the disclosure patterns and amount. Petty and Guthrie, rightly point out that one of the biggest challenges is to reach a consensus on three key questions: the need to report; what to report; and how to report(Petty and Guthrie, 2000)

Some of the models and methods that have been adopted by firms across the globe to measure and report IC areMarket Value added & Economic Value Added (MVA & EVA), Balanced score card,

Tobins Q, Intangible assets monitor, Skandia navigator, IC index and IC statement.

A very brief overview of the measures is presented below:

Stewart (1991) defines MVA as the excess of market value of capital (both debt and equity) over the book value of capital. If the MVA is positive, the company has created wealth for its shareholders. (Ramana, 2004) Simplest of all measures, the difference is attributed to intellectual capital as its contribution to value creation.

Economic value added (EVA), developed by Stern Stewart & Company, is the difference between the firm's after-tax return on capital and its cost of capital. Stewart (1991) defined EVA as residual return that subtracts the cost of invested capital from net operating profit after tax. EVA is equal to the economic book value of the capital at the beginning of the year and the difference between its return on capital and cost of capital. The concept of EVA helps in understanding the value creation process. (Ramana, 2004)

Another measure of performance, Tobin's q , is the ratio of the market value of a firm's assets (as measured by the market value of its outstanding stock and debt) to the replacement cost of the firm's assets (Tobin, 1969). If a firm is worth more than its value based on what it would cost to rebuild it, then excess profits are being earned. These profits are above and beyond the level that is necessary to keep the firm in the industry.

Balanced scorecard was originated to give managers and executives a more 'balanced' view of organizational performance. Kaplan and Norton describe the innovation of the balanced scorecard as "The balanced scorecard retains traditional financial measures. But financial measures tell the story of past events, an adequate story for industrial age companies for which investments in long-term capabilities and customer relationships were not critical for success. These financial measures are inadequate, however, for guiding and evaluating the journey that information age companies must make to create future value through investment in customers, suppliers, employees, processes, technology, and innovation" (Balanced scorecard Institute)

Intangible assets monitor is a method developed by Karl Sveiby for measuring intangible assets and particularly relevant for Knowledge Organizations. The monitor is a simple tool that displays indicators that indicate change, i.e. growth, and renewal as well as efficiency and stability measures. These measures may change with industry in which the firm operates and also the strategy adopted. The indicators related to external structure, internal structure and competence is provided which can be measured and reported. (Sveiby, 1996)

Skandia Navigator was developed by Leif Edvinsson to measure and report intangibles at Skandia. The navigator gives the balanced overview between financial and non-financial dimensions. The navigator takes through five varied focus which are financial focus, customer focus, human focus, process focus, renewal and development focus and human focus and is used as a planning tool as well as follow-up tool. (Edvinsson, 1997)

IC index first developed by Roos in 1997 is a well accepted measure of reporting intellectual capital of firms and it shows how

effectively the organization is using its IC. IC index seeks to identify key areas of focus that are vital for the organization and also provides an overall indicator of performance (OECD, 2003).

Some firms measure and report their IC in their customised manner, disclosing indicators that are relevant to their firm. IC statement is prepared on different dimensions of Intellectual capital- Human, relational and structural capital.

IC Disclosure: Some Theories

Having seen the models that are in place for measuring and reporting IC, in this section a brief review of the theories proposed for IC disclosure and the rationale behind such voluntary disclosure is attempted to be presented.

There are many theories that support the IC disclosures of firm; three theories that can be discussed in this context are stakeholder theory, legitimacy theory and signalling theory.

Stakeholders Theory: Traditionally shareholders were considered as the group to whom the firm is accountable for its performance; over years Freeman brought in the concept of stakeholders that is a larger group which would be impacted by corporate decisions. He asks the basic question "for whose benefit and at whose expense should the firm be managed" (Freeman, 1984)

Freeman and Reed (1983) distinguish two senses of stakeholder. The *narrow definition* includes those groups who are vital to the survival and success of the corporation. The *wide-definition* includes any group or individual who can affect or is affected by the corporation.

Stakeholders are defined usually to include shareholders, employees, customers, suppliers, competitors, lenders, government and communities; and groups representing environmentalists, the media, and consumer advocates (Clarkson, 1995); since the contribution of intangibles in the profit of firms is increasing, it is felt by management that the financial reporting should also include IC disclosure which would give the stakeholders a broader and correct picture of the true value of firm and performance.

Legitimacy theory: "Legitimacy theory is derived from the concept of organizational legitimacy, which has been defined by Dowling and Pfeffer (1975, p. 122) as: "... a condition or status which exists when an entity's value system is congruent with the value system of the larger social system of which the entity is a part. When a disparity, actual or potential, exists between the two value systems, there is a threat to the entity's legitimacy".

Legitimacy theory posits that organizations continually seek to ensure that they operate within the bounds and norms of their respective societies. In adopting a legitimacy theory perspective, a company would voluntarily report on activities if management perceived that those activities were expected by the communities in which it operates (Deegan 2002; Deegan, Rankin and Voght 2000; Cormier and Gordon 2001, Cuganesan, 2007)

The propagators of this theory view corporate reporting as an exercise of legitimizing the activities of corporation and validating the same within the given social environment.

Signaling Theory: Signaling theory is concerned with how to address problems arising from information asymmetry in any social setting. It suggests that information asymmetry should be reduced if the party possessing more information can send signals to other interest-related parties. Signaling theory suggests that companies with a high quality should signal their advantages to the market. It not only helps in reassessing the value of firm but also reduces the cost of capital (Davey, 2011)

Through the systematic literature review Bernard Marr & others were able to identify five main reasons as to why firms measure the Intellectual capital (Marr, 2003). These were:

1. To help organizations formulate their strategy;
2. Assess strategy execution;
3. Assist in diversification and expansion decisions;
4. Use these as a basis for compensation; and finally
5. To communicate measures to external stakeholders

Thus, it can be observed from the above reasons that firms that measure IC may not always prefer to disclose the IC and retain it only for internal use. The risks attached with disclosure such as losing out on competitive advantage, legal retaliation, regulatory interference, and the costs involved in measurement are some of the major reasons for the firms not communicating the IC to the external stakeholders.

Indian Scenario

The situation in India is not drastically different from other emerging economies, not many firms recognize the need and significance of measuring and reporting IC. The main reason can be attributed to lack of awareness among the top management regarding the benefits of disclosure in terms of value creation. Another most important reason is the shortage of funds available with firms for this specific purpose. The disclosure levels even firms that are intensive in knowledge assets is quite low.

Some of the firms that have resorted to/are voluntary disclosing IC are Balrampur Chini Mills Limited, Reliance Industries Limited, and Shree Cement Limited.(Patricia, 2005) Infosys Ltd. and Granules India Ltd. also have published IC statements and report respectively for few years.

The intervention that would be required at this stage for increasing the number and quality of voluntary disclosure would be two fold. One, the top management team of knowledge intensive firms is required to take leadership role in measuring and voluntary disclosure of IC for their firms, this would set an example for other firms to follow the road; in the mean time those firms who have reduced the information asymmetry would reap competitive advantage through value creation. Second important step that is required is to create awareness among the Small and Medium Enterprises (SME's) towards taking initiative to put in place systems related to managing knowledge and creation of IC; later they can be trained to measure and report IC.

Having analysed the need and significance of IC disclosure and the scenario in India, it can be said in conclusion that IC has come to play an important role in the process of value creation of firms. There are several theories that support the disclosure argument and research studies across globe have proved association between

corporate performance and IC disclosure. The Indian scenario regarding IC disclosure is that it has not taken off yet even among knowledge intensive industries. The suggestion that comes up is that voluntary disclosure practice must be encouraged in India as it has far reaching impact on performance and value creation.

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