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THE GREAT LOCKDOWN AND ECONOMIC RECOVERY IN DEVELOPING COUNTRIES

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AFRAG 025
Intellectual Capital Disclosure Practices in Emerging Economies
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Abstract
This paper assesses the incidence of intellectual capital disclosure (consisting of human, structural and relational disclosures) around the world. Intellectual capital disclosure has in recent years gained importance as there has been a rapidly growing realization of its importance as a whole in the financial statements of organisations. The paper reviews previous works by various scholars and practitioners on intellectual capital disclosure across various countries while also examining its relevance and applications. Findings reveal that there has been a consistently growing research interest in intellectual capital disclosure and its impact on the firms in emerging/developing countries. The paper concludes that disclosure of intellectual capital has been seen to further improve both the value and image of an organization; therefore, organisations in developing countries willing to enhance their corporate image should be involved in intellectual capital disclosure.

Keywords: Intellectual capital, Disclosure, Human capital, Structural capital, Relational capital, Emerging economies

1.0 Introduction
There has been an ongoing debate on the concept of intellectual capital (IC) and its disclosure in financial statements, which has gained prominence in recent years (Kasoga, 2020). IC has increasingly been seen as an integral part of firms’ value-creating processes (Cumby & Conrod, 2001; Sullivan, 2000). There has been a rapidly growing realization of the importance of disclosure of intellectual capital as a whole in the operation of organisations. Several Scandinavian companies have taken the global lead in this regard, such as Skandia, Carl-Bro and Ceremi, who have all publicly disclosed intellectual capital statements.
In a knowledge intensive economy, a company’s intellectual capital, whether it is derived from its employees, customer databases or brands, undoubtedly contribute to a company’s success and its ultimate value. Most of these intangible assets cannot be included within a company’s balance sheet and intellectual capital disclosures in the annual report and financial statements have been largely voluntary. The role of intellectual capital (IC) in creating value has become crucial in achieving a competitive advantage in the market place (Usoff et al., 2002). This role is highlighted in (Drucker, 1993) whereby it was stated that knowledge has become the key economic resource and the dominant and perhaps even the only source of competitive advantage.

Prior literature tends to define intellectual capital (IC) as non-monetary assets or resources without physical substance, such as innovation, knowledge, research and development, employee training or customer satisfaction, underlying a firm’s value creation process (Lev & Zambon, 2003). The importance of IC resources in a firm’s value creation process has continuously increased due to the transition from manufacturing-based economies towards knowledge-based economies (Barth & Clinch, 1998; Kallapur & Kwan, 2004). IC is a key issue in strengthening a firm’s competitive position and in achieving its objectives (Guthrie & Petty, 2000). In recent years, companies have become aware of the importance of managing external communication systematically with respect to intellectual capital.

Various studies of investors’ and analysts’ requests for information indicate a substantial difference between the type of information found in companies’ annual reports and the type of information demanded by the market, such as (Eccles et al., 2001; Eccles & Mavrinac, 1995). In general, companies, investors and analysts request more reliable information on, for example, managerial qualities, expertise, experience and integrity, customer relations and personnel competencies – all factors related to intellectual capital. The importance of intellectual capital and its management to the organisation is not really a new phenomenon (Abdulaali, 2018). Awareness of its value has grown substantially in recent years. Over the last decade, there has been growing recognition that these types of assets have become the most valuable and fastest growing part of any economy (Omiunu, 2019). Studies have revealed that users of financial report now require more information than what eyes could see in the published financial statement.
Today it is clear that intellectual assets and their effective management, in fact, may be the only form of sustainable competitive advantage for any firm. As the burgeoning demand for knowledge-based products and services is changing the structure of the global economy, the role of intellectual capital in achieving competitive advantage is becoming an important management issue in all sectors. Despite the awareness on intellectual capital disclosure across the globe, a larger part of corporations in various countries have not included intellectual capital items in their financial statements. This study, therefore, aims to systematically review the findings of several literature on the concepts of intellectual capital in order to shed more light on disclosure practices of firms in emerging economies.

2.0  Statement of Methodology

Due to the need for the examination of previous literature concerned with research on IC disclosure practices, this study adopted library research as its research method which involved identifying, selecting and critically appraising literature sources in order to write a paper (George, 2008). The documents involved in this case are the research papers with findings in the study area on one hand, and the relevant published annual reports and financial statements on the other hand. The findings were collated and classified based on region (developed, emerging and Nigeria) to give a more holistic overview of IC disclosure practices. No sampling techniques were adopted since all the articles searched for were reviewed.

3.0  Concept of Intellectual Capital

Intellectual capital (from here on referred to as IC) is defined in different ways. In other words, it is a set of non-financial, non-physical resources that procure a competitive advantage for the enterprise (Jussupova-Mariethoz & Probst, 2007). IC can also be defined as the difference between a firm’s market value and its book value, or the resource created from internal learning and development of valuable relationships (Ordóñez de Pablos, 2003). Any monetary investments made by a company in expectation of future profits that are not immediately embodied in intangible form constitute an intangible asset and, in most cases, an intellectual capital (Coakes & Bradburn, 2005). Mouritsen et al. (2001) suggested that intellectual capital is the aggregate sum
of intangible assets which comprise both human and structural capital. Peng et al. (2007) and Roos et al. (2005) defined intellectual capital as all non–monetary and non–physical resources that are fully or partly controlled by the organization and that contribute to the organization’s value creation. It has also been defined as knowledge that can be converted into profit (Harrison & Sullivan, 2000). Wood (2003) states that IC is information in people’s minds. IC is also intellectual materials – knowledge, information, intellectual property, experience – that can be put to use to create wealth (Isaac et al., 2009). Brooking (1997) defined intellectual capital as the combination of intangible assets which enable the company to function. A key feature of the definitions of intellectual capital is that they recognise the link between intellectual capital and the structure and performance of an organisation. They reflect the uniqueness of intellectual capital to individual firms in enhancing their competitive advantage.

4.0 Historical Perspectives of Intellectual Capital Disclosure/Reporting

IC disclosure/reporting began as an accounting/management practitioner-created concept. In the early 1990s, Scandinavian organisations such as Skandia, Ramboll and GrandVision realised that existing financial accounting frameworks were unable to adequately address the measurement and recognition of the new value drivers in the economy. These organisations developed their own frameworks and methods for measuring and managing intellectual capital. It has only been more recently that scholarly contributions appeared to analyse and use the potential offered by IC reporting (Bontis et al., 1999; Bounfour, 2002; Brooking, 1997; Edvinsson, 2000; Guthrie et al., 2001; Sveiby, 1997).

Behind intellectual capital reporting, there is an idea that the traditional financial information concerns the past performance of the company and not that of the enterprise’s future potential. Reporting of intellectual capital will create a transparency that allows the manager of the enterprise to manage its intangible resources better. By creating transparency, it helps management to allocate resources, to monitor development and to create strategy. In summary, it facilitates decision making for companies (Roxana-Manuela, 2011). There are two main reasons for intellectual capital reporting; firstly, reporting of IC provides additional information which can be used to improve the management of the company as a whole; and secondly, reporting of IC complements
the financial statement of the company and therefore provides a broader, more truthful image of the company (Basta & Bertilsson, 2009). As discussed in Section 4.0 (classification of intellectual capital) above, both the statement of financial position and the statement of comprehensive income should carry the specific amounts of each item of human and structural capital as discussed.

Internal strategic decision-making and external disclosure should focus on IC information such as staff competencies, managerial capabilities, customers’ and suppliers’ relationships, strategic collaborations, R&D, organisational systems etc. Guthrie et al. (2001) identified two evolving intellectual capital (IC) missions: firstly, by developing systems for creating, capturing and disseminating IC within organisations for internal strategic decision-making and, secondly, by establishing new measures and ways of reporting externally the value attributable to IC. The latter mission addresses information needs of the managers for internal management of the company and information needs of investors for valuing the firm as an investment opportunity.

5.0 Classification of Intellectual Capital
Whilst there is a wide range of definitions, there seems to be broad consensus that intellectual capital comprises three major categories:

1. Human Capital – Human capital involves processes that relate to training, education and other interventions in order to increase the levels of knowledge, skills, abilities, values and social assets of an employee which will lead to the employee’s satisfaction and performance and eventually on a firm performance (Rizvi, 2011). Okpala and Chidi (2010) explained that human resource accounting relates to the quantification in monetary terms of human resources employed by an organization and assert that a well-developed system of human resource/capital accounting could contribute significantly to internal decisions by management and external decisions by investors; they are expensed instead of being treated as assets in the balance sheet. Li et al. (2008) developed the most comprehensive list of intellectual capital information comprising 61 items from a review of several previous studies (such as Beattie & Thomson, 2007; Bozzolan et al., 2003; Guthrie & Petty, 2000) as well as statements of best practice. Human Capital makes up 20 of the 62 components, which include number of employees, employee motivation, employees age, employee productivity, employee diversity, employee training, employee equality, vocational
qualification, employee relationship, employee development, employee education, employee flexibility and skills/know-how/expertise/knowledge, entrepreneurial spirit, employee work-related competences, employee capabilities, employee work-related knowledge, employee teamwork, employee attitudes/behavior, employee involvement with community, employee commitments and other miscellaneous employee features.

Measurement and disclosure of human capital in the statement of comprehensive income include expenditure on advertisement for recruitment; cost of selection and hiring; on-the-job and off-the-job training costs; subsistence allowance; contribution to pension fund; educational and tour expenses; medical expenses; ex-gratia payments; employee's welfare fund; and, most commonly, salaries and wages.

2. **Structural capital** – According to Harrison and Sullivan (2011), structural capital encompasses the hardware, software, database, systems, work processes, business models, organizational structure, patents, trademarks, trade secrets and all other codified knowledge. According to Li et al. (2008), it comprises 21 items which include intellectual property, technology, process, financial relations, management philosophy, customer support function, corporate or organisational culture, knowledge-based infrastructure, organisational flexibility/adaptability, quality management and improvement, organisational structure, accreditation, organisational learning, overall infrastructure/capability, research and development, networking, innovation and distribution network.

Measurement and disclosure of structural capital in the financial statements is partly embedded in the fixed assets, while the others are presented in a narrative style.

3. **Relational capital** – Boedker et al. (2004), Guthrie and Petty (2000), Lev and Zambon (2003) defined relational capital as all resources linked to the external relationships of the firm, with customers, suppliers, or partners in research and development. It comprises that part of human and structural capital involved with the company’s relations with stockholders (investors, creditors, customers, suppliers), plus the perceptions that they hold about the company. It also includes the image of the organization in the market, its social identity and brand equity (Gupta & Bhasin, 2014).
According to Li et al. (2008), relational capital also has 21 areas of expertise such as customers, diffusion and networking, market presence, brands, customer relationships, distribution channels, customer acquisition, relationship with suppliers, customer retention, business collaborations, customer training and education, business agreements, customer involvement, favourable contracts, company image/reputation, research collaborations, company awards, marketing, public relations, relationship with stakeholders and, finally, market leadership.

In hindsight, the value of these intellectual capital components can be difficult to identify through financial transactions, and the use of non-financial indicators is a way to provide intellectual capital measurement (Oleksak & Oleksak, 2010). It is not always possible to capture intellectual capital in accounting systems of organizations because they are almost invisible in conventional forms of information systems. Furthermore, there is a lack of standard metrics for relational capital evaluation of organizations (Barão & Da Silva, 2011).

### 6.0 Concept of Intellectual Capital Disclosure

Intellectual capital disclosure is defined by Abeysekera and Guthrie (2005) as a report intended to meet the information needs common to users who are unable to command the preparation of reports about IC tailored so as to specifically satisfy all of their information needs (Gan & Saleh, 2008). IC 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). This type of intellectual capital disclosure is valuable information for investors, as it can help them to reduce the uncertainty of the company’s future prospects and assist in firm valuation (Bukh, 2003). There are many reasons for the companies to disclose intellectual capital information in their annual reports. These include helping organizations formulate their strategies and assess strategy executions, assist in diversification and expansion decision, using as basis for compensations and to communicate measures to external stakeholders (M. Bhasin & Shaikh, 2011).

According to Bhasin (2012), disclosure of intellectual capital will raise some benefits for the organization. Some of the benefits are enhancing transparency in terms of more disclosure on intangible information rather than tangible information, helping to inspire a sense of faith among
the workforce other major stakeholders and supporting long term vision of the organization (Taliyang et al., 2011).

Intellectual capital disclosure also comes at a cost, such as the cost of gathering, processing and interpreting the necessary data. Vergauwen and van Alem (2005) identified three other opposing factors for intellectual capital disclosure, such as the transparency drawback in competitive markets, regulatory barriers, and auditor conservatism. However, overall, the benefits of disclosure outweigh the costs because the value of the firm increases with increase in its assets. This is because IC disclosure establishes trustworthiness with stakeholders and employs a valuable marketing tool (Van Der Meer-Kooistra & Zijlstra, 2001). According to Toms, (2002) and Guthrie et al. (2006), it enhances external reputation and also appears legitimate in the public eye by avoiding costs from non-legitimacy (Beattie & Thomson, 2007; Deegan & Unerman, 2006). IC disclosure will enhance transparency in terms of more disclosure on intangible information rather than tangible information. Lastly, it will support the long-term vision of the organization (Taliyang et al., 2011).

A number of explanations have been provided in the literature to explain why firms might voluntarily measure and report intellectual capital. Guthrie et al. (1999) classified these incentives into those relating to the internal activities of the firm and those relating to the external environment that impacts the firm. From the perspective of the internal environment, measuring and reporting intellectual capital is said to benefit the firm via increased operational efficiency, improved employee morale and motivation, and better resource allocation with the firm (Flamholtz & Main, 1999; Guthrie et al., 1999). In the context of the external environment, the overriding incentive for firms to engage in voluntary disclosure of intellectual capital is to render the invisible visible to external users of information, and to also create more value (Beattie & Thomson, 2007; Cooper & Sherer, 1984; Göran Roos & Roos, 1997).

7.0 Theoretical Framework
The thought on the importance of the disclosure of intellectual capital will be analyzed using three theories. They are Stakeholder theory, Legitimacy theory and Signaling theory.

1. **Stakeholder theory** – An organization’s management is expected to take on activities expected by their stakeholders and to report on those activities to the stakeholders (Žukauskas et al., 2018). This theory also suggests that all stakeholders have a right to be provided with information about how organizational activities impacts on them, even if they choose not to use the information, and even if they cannot directly play a constructive role in the survival of the organization (Deegan, 2002). Stakeholder theory suggests that every legitimate person or group participating in the activities of the firm do so to obtain benefits for all stakeholders and companies (Donaldson & Preston, 1995). It is argued that firms have stakeholders rather than just shareholders to account for. This means that the groups that have a stake in the firm may include shareholders, employees, customers, suppliers, leaders, the government and society. Thus, this theory emphasizes on the fact that organizations should disclose intellectual capital information for the benefits of all stakeholders, including its management.

2. **Legitimacy theory** – This theory is closely linked with the stakeholder theory. Legitimacy theory hypothesizes that organizations will ensure that they operate within the limits and standards of the societies they are in (Žukauskas et al., 2018). By adopting a legitimacy theory, a company would voluntarily report on activities if management perceived that the particular activities were expected by the communities in which it operates (Deegan, 2002). Hence, this theory encourages the organization to voluntarily disclose intellectual capital information for the benefits of society.

3. **Signaling theory** – It is based on two general assumptions (Myers & Majluf, 1984). Firstly, managers are better informed than shareholders or the public concerning of firms’ positions. Secondly, given that managers have information advantage, they may choose to disclose information in an attempt to signal to the public regarding firms’ positions. The signaling theory suggests that more profitable firms will disclose more information to inform their stakeholders about their good performance. In other words, firms with good performance are more likely to disclose more information regarding the intellectual capital as compared to firms with bad performance.
Based on these explanations, the theory which best explains the problem of this study is signaling theory because it is involved with financial information disclosure (in this case, intellectual capital disclosure) and its relationship with firm performance.

8.0 Intellectual Capital Disclosure Practices

In the course of investigating intangibles/intellectual capital disclosure trend among industries, it was discovered that the annual report is the most common disclosure medium (Abeysekera et al., 2007; Guthrie et al., 2006; Vergauwen et al., 2007). Guthrie and Petty (2000) pointed out that annual report is viewed as a communication device used by companies to convey their information to various stakeholders. Previous literature, however, provides example where researchers such as Nikolaj Bukh et al. (2005); Cordazzo and Vergauwen (2012) and Singh and Van Der Zahn (2008) have ascertained the importance of these reports in attracting potential investors through their disclosing intellectual capital information. It is worthy of note that prospectuses and annual reports are tailored to the specific needs of different users.

Unlike the annual report that focuses on historical performance, a prospectus provides information that focuses on the company’s future perspectives. Cordazzo and Vergauwen (2012) asserts that a prospectus offers additional information on the companies’ long-term strategy, company risk and future profitability, and it is generally more forward-looking than an annual report. These differences are likely to be reflected in the disclosure practices of the two documents. However, literature on intangibles or intellectual capital disclosure studies comparing prospectus with annual report is scarce.

In a slightly similar study, Nielsen et al. (2009) observed similarities between prospectuses with intellectual capital statements. They further argued that a common framework for analysing business reporting could be developed based on the findings. According to Lev and Zambon (2003), economic development in recent years has been characterised by continuous innovation, the spread of digital and communication technologies, the relevance of network forms of organization, and the prevalence of soft, intangible and human factors. Firms operating in competitive, global markets recognize that the traditional reliance on tangible assets as value
drivers has been supplemented – or even superseded – by softer, intangible asset forms. Hence, for most organizations, intellectual capital is now recognized as an integral part of the firms’ value-creating process because it includes the entire wealth of ideas relating to the organization, as well as the ability for innovation, which highly determines the future value of the firm (Bukh, 2003; Holland, 2003).

9.0 Intellectual Capital Disclosure in Developed Countries

In a review of the current state of financial and external reporting research, Parker (2007) identified intellectual capital accounting as a major area for further research. Most intellectual capital disclosure studies are cross-sectional and country specific. Examples include studies in Australia (Guthrie & Petty, 2000; Sujan & Abeysekera, 2007), Ireland (Brennan, 2001), Italy (Bozzolan et al., 2003), Malaysia (Goh & Lim, 2004), UK (Duff, 2018) and Canada (Bontis, 2003).

A lesser amount of longitudinal studies have been reported (Abeysekera & Guthrie, 2005). Some studies focus on specific aspects of intellectual capital disclosure, such as human capital reporting (Subbarao & Zeghal, 1997), while others conduct international comparative studies (Cerbioni & Parbonetti, 2007; Vergauwen & van Alem, 2005). Some intellectual capital disclosure studies have looked beyond annual reports to examine other communication channels such as analyst presentations (García-Meca & Sánchez-Ballesta, 2009).

Vandemeale et al. (2005) conducted a study of intellectual capital disclosure practices in the Netherlands, Sweden and UK. They documented an increasing trend in all the three countries over the 1998 to 2000 three-year period. Meanwhile, Guthrie et al. (2006) investigated the intellectual capital reporting practices in Australia, Hong Kong and document low amounts of intellectual capital information in annual reports in both countries.

In a UK study, Deegan and Unerman (2006) showed substantial intellectual capital disclosures even in sectors in which intellectual capital is not expected to be a significant value driver, such as real estate, retail and utilities. Studies also revealed that intellectual capital disclosure is still very much an academic discussion in Canada. There is no evidence at all that intellectual capital disclosure has garnered any traction for Canadian corporations. Only a small percentage of Canadian companies even used the terms in their annual reports. Obviously, using the language of
intellectual capital is an important antecedent to developing intellectual capital statements, but Canada seems to be significantly behind its developed economy counterparts.

Studies carried out on Australian firms revealed that the industry type plays a key role as determinant for the disclosure of intellectual property in annual reports. In addition, firm size is another determinant for intellectual disclosure of firms. Scrutinizing across industries indicates different level of IC disclosure among sampled firms. Specifically, high-tech industries such as Health Care, Information Technology, and Telecommunication Services were among the industries aggressively provided IC information.

10.0 Intellectual Capital Disclosure in Emerging Countries

There is a growing research interest in intellectual capital disclosure in developing/emerging economies (Khan & Ali, 2010). In the Asian context, IC reporting research is also documented. Goh and Lim (2004) is a study of 20 Malaysian firms, which indicated that the nature of IC voluntary disclosures in company reports is highly qualitative rather than quantitative. In a study of 30 firms listed on Sri Lanka’s Colombo Stock Exchange using the content analysis method, Abeysekera and Guthrie (2005) examined annual reports of the top 30 listed firms in Sri Lanka for the period 1998/1999 and 1999/2000 and observed an increase in intellectual capital disclosure which also provided evidence of reporting focusing more on external capital than human capital.

In a subsequent comparative study of IC reporting in Sri Lanka and Singapore, Abeysekera (2008) identified differences in IC disclosure between Sri Lankan and Singaporean firms and suggested reasons for dissimilarities from country standpoints. In the context of Pakistan, Makki et al. (2009) attempted to measure IC performance among 25 companies listed on the Lahore Stock Exchange using the VAIC model. Their findings conclude that the oil and gas, chemical and cement sectors show top performance in terms of IC components; the banking sector illustrates average performance, however, with public sector organisations evidencing the lowest levels of disclosure.

It is worthy of note to state that the release of Statement of Accounting Standard (SAS) number 22 by Nigerian Accounting Standard Board (NASB) in June, 2006 marks the beginning of standardization on reporting of intellectual capital by companies in Nigeria. Before this time,
Nigeria did not have any accounting standard on intangible assets and did not adopt the International Accounting standard (IAS) 38. However, even though that none of the widely published IC disclosure researches at that time was conducted in Nigeria, the situation has improved drastically over the ensuing decade. The above submission indicates that substantial researches on IC disclosure have been conducted in developing countries in general and Nigeria in particular.

Despite the prominence given to the efforts of the workforce in the annual financial statements of companies in Nigeria, the measurement of intellectual capital in Nigeria is quite novel. It is true that human capital is acknowledged by the treatments of companies especially in the chairman’s statement in the annual reports, yet such knowledge is not measured or articulated in the company’s financial reports. This means that the intangible value of firms in Nigeria is under reported. Furthermore, studies on the measurement of intellectual capital are currently not detailed.

Epetimehin (2011) observed that intellectual capital as a vital corporate asset, will melt away unless companies do something to stop the brain drain and to retain critical knowledge. He opined that the survival of the insurance companies in Nigerian is dependent upon the resolve of the workforce to eliminate unethical practices which are resorted to avoiding liability under insurance policies. Onyekwelu and Ubesie (2016) studied on pharmaceutical companies in Nigeria and analyzed the effect of intellectual capital on corporate valuation from 2004 to 2013 using market to book value ratio (MV/BV) and earnings per share (EPS) adopting Pulic (2000) VAIC; the results show that human capital efficiency has a positive and significant effect on market/book value. Structural capital has a negative and insignificant effect on EPS.

In the same vein, Ekwe (2012) found out a statistically strong relationship between the components of intellectual capital and market to book value M/BV ratio of banks listed on Nigeria Stock Exchange. Yahaya (2006) used the quantitative measure published by the Institute of Intellectual Capital Research and approved by the Saratoga Institute to measure the impact of investment in human training and development on employee’s effectiveness in Nigerian Banks between 2001 and 2005. Her study confirms that an assessment of the human resource effectiveness of 3 commercial banks (Zenith Bank, First Bank and Union Bank) showed that Zenith Bank with the
best human resources management and accounting practice performed better than First Bank and Union Bank.

11.0 Conclusion
This study’s original aim was to examine the IC disclosure practices of firms in emerging economies. The study introduced the background of IC and its disclosure, its importance and the rise in public awareness. Important concepts such as intellectual capital and its three primary classes of human, structural and relational capital were discussed. Furthermore, the concept of IC disclosure, its motivation, benefits and historical perspectives thereof were also discussed. Furthermore, the theories underlying these concepts were put forward and contextualized, while IC disclosure practices in both developed and developing/emerging economies were outlined.

It is evident that the concept of intellectual capital disclosure is gaining ground across the globe. Studies have revealed that investors and users of accounting information now require more disclosure than what is obtained in financial statements previously prepared and published by managers of corporate organisations. Disclosure of intellectual capital has been seen to further improve the image of an organisation, so those willing to enhance their financial values as well as their image should be involved in intellectual capital disclosure.

It is hereby recommended that the trend of IC reporting/disclosure which shows an upward, positive movement should be maintained into the future. The advent of the knowledge economy makes it easier to measure/quantify the extent of intellectual capital in its different forms; thus, all firms should ensure they benefit from boosting their book and market values by properly accounting for these intangibles year-in-year-out. All stakeholders’ hands should be on deck to ensure proper reporting practices are objectivity and transparency.

References


