

# Intellectual Capital Disclosure: Concept and Practices

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## ABSTRACT

In a rapidly changing world evidenced by a transition from industrial to knowledge economy, knowledge sector has attracted the attention of the entire globe. The future drivers of any economy will no longer be capital, land or equipment; but the people and their knowledge. Corporate sector, now, is in search of a new paradigm in accounting, which would enable it to record its new journey from financial capital to intellectual capital. In this study we have decided to investigate the concept and the intellectual capital disclosure practices using as the source of our documentation books, articles, working papers and online publications. So, in the first part of our research we have presented several points of view in respect to the concept of knowledge assets or intellectual capital and in the second part we have reviewed the literature on the topic highlighting several scholars opinion on reporting and disclosure issues.

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## 1. Introduction

The world is moving from industrial economy to knowledge economy. Indian economy has attracted the attention of the entire globe with its transition from production to knowledge-based economy. In this transition, India emerged at the top. The growing software and IT, financial services, business outsourcing, media, healthcare, pharmaceutical industries etc, have lead to increasing investments in intangible assets. This scenario has changed the business mind set, as all are interested in finding the innovative ways to present their organizational value. In such knowledge-driven global market place, intangible assets such as intellectual property, brands, customer relationship and talent hold much more value than tangible assets. According to an extensive global survey conducted by Global Intangible Tracker (GIT- 2007), India ranked third in the world with the highest (74%) intangible component as a % of total enterprise value (TEV), next to US (75%) and Switzerland (74%). India, also, stood first in the ASEAN economy. Global intangible to TEV average is around 65%. As Indian economy grows, it is likely to increase the lead. TEV is measured in terms of value of disclosed and undisclosed tangible and intangible assets. GIT considered the top 50 companies (by market cap) on the Bombay stock exchange. The GIT study has been considered significant in the wake of changes in the accounting practices as the valuation of intangible assets has become an indispensable boardroom issue

Recognition and disclosure of intangibles is an important contemporary issue in the accounting and finance literature (Lev & Schwartz 1971, Guthrie et al. (2003). There is no provision for disclosing intangibles under the prevailing reporting practices. Rather, the disclosure of such intangible assets is presently restricted. Corporate financial reporting needs to evolve to include such elements that create value-for business such as customer satisfaction, brand valuation, business collaborations, and corporate culture etc. Stakeholders are strongly interested in knowing the true value

of the firm and information about company's intangible assets. The Financial Accounting Standard Board (FASB) requires that financial reporting should provide information that is useful to present and potential investors, creditors and others, in making rational investment, credit and other financial decisions. Therefore, recognition, measurement and disclosure of the intangible resources and providing such information to stakeholders are considered as an important activity within a company. Researchers believe that it would certainly improve the quality of decisions of such stakeholders.

## 2. Review of literature

Since intellectual assets became integral part of value-creating process in any company, its external communication to stakeholders has become necessary. World over, several studies have examined the extent of reporting intellectual capital. Brennan, Ireland (2001), Bozzolan et al., Italy (2003), April et al., South Africa (2003), Goh & Lim, Malaysia (2004), Abeysekera & Guthrie, Srilanka (2005), Sujana & Abeysekera, Australia (2007), Ali et al., Bangladesh (2008) are the examples of studies based on 'content Analysis' of Annual report of the sample companies. These studies followed Sveiy (1997) framework and the findings of all these exponents reveal that External capital is the most reported intangible assets in the sample companies. Relatively very few longitudinal studies have been reported (e.g. Abeysekera and Guthrie, 2005, Number of disclosure items in the index was 45). Moreover, some studies focused on the specific aspects of Intellectual Capital reporting, such as human capital reporting (e.g. Subbarao and Zeghal, 1997), while others conducted international comparative studies (e.g. Vergauwen and van Alem, 2005; Cerbioni and Parbonetti, 2007). Some Intellectual Capital reporting studies have looked beyond annual reports to examine other communication channels, such as, analyst presentations.

India presents an ideal case for the analysis of Intellectual Capital reporting by the many corporations because the

economy has undergone a rapid transformation in the financial services, tourism, information technology sectors, and the niche manufacturing gaining momentum. In the Indian context, there has been very limited number of Intellectual Capital reporting studies, as compared to its European counterparts. However, very few recent studies are available on intellectual capital reporting in India using content analysis, by Kamath (2008), and Joshi et al. (2009), Chander & Mehra (2010).

*Research Gap:* The review of literature shows that a number of studies have been conducted worldwide, and only few studies found in India are also inconclusive. There is a need for literature on the subject in the Indian context. In addition, there is an increasing significance of intangible assets in the Indian corporate sector. Thus, the present study builds on the previous literature of intellectual capital reporting practices and overall Intangible assets reporting scenario in the Indian corporate sector. The specific objective of the study is as follow:

*To investigate the concept of the intellectual capital*  
*To investigate the disclosure practices of intellectual capital*

### 3. Concept and constituents of intellectual capital

Lev (2001) used the terms intangible assets, knowledge capital, and intellectual capital interchangeably. He argues that these terms differ only in terms of their origin and discipline. He refers intangible assets to intellectual capital for managers and advocates. Edvinsson & Malone (1997) says that intangible assets are hidden capabilities of an organization. Intangible assets can also be referred as knowledge based resources that contribute to the creation of a competitive advantage for the firm (Ordonez de Pablos, 2005). The Organization for Economic Co-operation and Development (OECD, 2000) describes intellectual capital as the economic value of two categories of intangible assets of a company; organizational capital and human capital. According to the Indian Accounting standard (AS 26) an intangible assets is an identifiable non-monetary asset without physical substance held for use in production or supply of goods and services for rental to others, or for administrative purposes. Brooking (1997) describes intellectual capital as combined intangible assets of market, intellectual property, human-centered and infrastructure which enable the company to function. Intellectual capital is the net difference between the market value of a company and the book value of its tangible assets. Intellectual capital is an individual knowledge stock of an organization as represented by its employees (Bontis, 2003).

Most of the early exponents equate intellectual capital to intangible assets. Garcia-Parra et al. (2009) suggested to include intangible liabilities in the concept of intellectual capital and have given the refined meaning of it. One of the most comprehensive definitions of Intellectual Capital is offered by the Chartered Institute of Management Accountants (CIMA): —The possession of knowledge and experience, professional knowledge and skill, good relationships, and technological capacities, which when applied will give organizations competitive advantage. From the above study, it can be concluded that Intellectual capital is the collective assets of an

organization represented by the skill and experience of its employees, corporate information repositories, and reliable indicator of the future earning potentialities. More appropriately, intangible assets or intellectual capital of a company have been analysed under four categories- Human Resources, External capital, Internal capital and Intellectual property assets (Guthrie; petty & Johanson, 2001; Vergauwen & Alem, 2005; Chander & Mehra 2010).

*Human Capital:* Human capital or Human Resource is the most important factor. It represents the individual knowledge stock of an organization represented by its employees that differentiates organizations. (Bontis, Crossan & Hlland, 2002). Human capital includes the specific individuals that cannot be owned or copied by competitors. Further, a company can increase its value and gain a sustainable competitive advantage by investing in human assets.

*External assets:* External assets are intangibles that are related to market and enhance company's market potentialities for its success. These represent the relationship that a company established with its customers, suppliers, business partners, industry association, channels of distribution, investors, society, etc.

*Internal capital:* These assets are constantly under the control of an organization. They represent an organization's unique advantage over its competitors, as these assets are not licensed to outsiders. Internal capital comprises - assets and capabilities of a company, its infrastructure and organizational processes, systems, technologies, information, methods, and culture and other category of assets, in the production of goods and rendering services to the market. These are sensitive to business dynamics.

*Intellectual Property Assets:* Other category of assets included in the internal capital is intellectual property assets. The only difference is that a company can derive incomes from licensing these assets to outsiders. These are owned and controlled by an organization and include know-how, copyrights, patents, products and tools.

### 4. Intellectual capital reporting practices

Several scholars have concentrated their efforts toward understanding and analyzing intellectual capital reporting practices. For instance, Abeysekera and Guthrie (2006) identify the following categories of intellectual capital reporting: ratios and values; reporting intellectual capital via intellectual capital statements; theoretical models. Concerning reporting intellectual capital as ratios and values Roos et al. (1997) states that intellectual capital is by definition intangibles and therefore the only possible way to measure them is by proxy variables or indicators. Authors like Abeysekera and Guthrie (2006) considered that there techniques could be classified into two broader sub-categories: the firm macro level for inter-firm comparisons; and of measuring and reporting within firm level (micro) for interdivisional comparisons. In regard to reporting intellectual capital through intellectual capital statements, empirical models have been proposed to measure intellectual capital items. Some models used activity based costing to determinate cost and market value to determine

revenue. In Abeysekera's vision (2001) another conceptual approach is to report intellectual capital in relation to the "fair value" of the firm and to recognize intellectual revenue or intellectual expense as the difference of fair value between two periods within the traditional accounting system. Also, Abeysekera and Guthrie (2006) identified five major frameworks of intellectual capital reporting: structures holding intellectual assets, developed by Sveiby (1997), focused on intellectual assets; capital holding intellectual items, that analysis intellectual capital in relation to intellectual assets (Edvinsson, 1997; Roos et al., 1997) assets representing intellectual capital, that focused on intellectual assets and was in Brooking (1999) interest; strategic and measurement root focused on the role of intellectual capital, that was in attention of Roos et al. (1997) research and a combination of assets and capital representing intellectual capital, developed by IFAC in 1998 and Dzinkowski (2000). As Abeysekera (2001) noted annual reports are an ideal research location for applying the intellectual capital framework because they provide a good proxy with which to measure the comparative positions and trends of intellectual capital between firms, industries and countries. Several papers and studies that we have found in the literature concerning intellectual capital issues has used annual reports as source documents to discover the status of intellectual capital of companies (Abeysekera and Guthrie, 2005; Brennan, 2001; Vergauwen and van Alem, 2005). The value-creation capabilities of different organizations and entities are studied in the last decade by several authors like Edvinsson (2002), Bontis (2004), Tallman et al. (2004), Schiuma et al. (2005). Also, several theoretical contributions have underlined the strategic importance of intangible resources for the value creation capabilities, some of them tried to build approaches and tools more oriented towards project and management processes or analyzed the relationship between knowledge resources, value creation

capabilities and competitiveness (Bontis, 2004; Bonfour and Edvinsson, 2005; Pulic, 2005). Lev and Sougiannis (1996) valued and calculated intangibles and then correlated those values with financial measures while Edvinsson (1997) identified the so called "hidden values" of a company and developed an intellectual capital management model. Also, various prior studies have suggested that the level of intellectual capital disclosure in annual reports is relatively low.

## 5. Conclusions and limits of the research

There is a growing awareness that intellectual capital is a key asset for success in today's economic environment. Intellectual capital is not just data or information in files and databases. It comprises all useful knowledge in whatever form in the organization. Intellectual capital is critically important in knowledge-based organizations and is becoming increasingly important in every other type of organization. Therefore, it is critically important that intellectual assets be well understood and properly managed if organizations are to compete successfully in today's world economy. Effective management of intellectual capital begins with understanding. For this reason, this paper has provided a definition of intellectual capital to help managers understand the breadth of management requirements. As it can be understood from the above presented issues concerning the intellectual capital concept and reporting practices we did not find in the studied literature on the topic much homogeneity and uniform views. Also, our work was a difficult one taking into account the very rich and diverse literature. However, we consider that we have synthesized the main or important aspects regarding the definition and reporting of knowledge assets. But, there are a few aspects that were not discussed and this is surely one of the limits of our study.

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