Disclosure Practices of Intellectual Capital in Sri Lankan Context

Larojan, C.[a]; Fernando, A J [b]

[a]Department of Finance and Accountancy, Vavuniya Campus [b]Department of Accounting, University of Sri Jayewardenepura *lrojanc@vau.jfn.ac.lk ; p.anil.jayantha@gmail.com*

Abstract

In the today's Knowledge-Based Economy (KBE), Intellectual Capital (IC) is considered as a strategic asset which determines the value of the company. Different practices of disclosing the IC information in annual reports do not result in the real value of the financial position of the company, is the main problem in Sri Lankan companies. The objectives of this study are to examine the nature of disclosing the IC information based on the content analysis of annual reports and to reveal the significant findings of past Sri Lankan Intellectual Capital Disclosure (ICD) research studies. Most of the Sri Lankan listed companies are now being disclosed ICD in the text, sentences, pictures, tables and graphs with the core discipline of Global Reporting Initiative [GRI] guidelines in their annual reports. The study offers an insight into the corporate and business level managers, policy makers and potential investors.

Keywords:

global reporting initiative [GRI] guidelines, intellectual capital (IC), intellectual capital disclosure (ICD) and knowledge-based Economy (KBE)

Introduction

At present, the world economy is transiting from an industrial economy to a Knowledge-Based Economy (KBE) in order to enhance the wealth creation (Abhayawansa 2013). As per this transition, to be sustaining the competitive advantage, the economy has to depend on the knowledge-based capital so called the Intellectual Capital (IC), such as knowledge workers, employee-related measurements, patents, trademarks, organizational systems and business strategies (Rashid 2010).

As far as stakeholders of the companies are concerned, the annual report is one of the primary methods used to communicate the companies‘ response to stakeholder concerns. It is the right of all stakeholders to obtain all the information about the company, including IC information. Sri Lanka Accounting Standard for intangible assets - LKAS 38 sets out the accounting treatment, recognition and measurement of intangible assets of the companies' financial statements. As per this Standard, the term intangible assets are defined as an identifiable non-monetary asset that is not physical and owned to be used in generating or handling over goods and services.

The LKAS 38 (para. 68) describes the recognition of an expense of Intangible Assets as:

> [e]xpenditure on an intangible item shall be recognized as an expense when it is incurred unless: it forms part of the cost of an intangible asset that meets the recognition criteria or the item is acquired in a business combination and cannot be recognized as an intangible asset.

If this is the case, it forms part of the amount recognized as goodwill at the acquisition date in a Business Combination as per SLFRS 3 (LKAS 38, para. 68). As Brännström and Giuliani (2009, p. 22) suggest, ‗IFRS 3 can be seen for the financial accounting issue as a possibility to disentangle the black-box of purchased goodwill and to adhere to some of the critique emanating from the IC debate'. The IAS and LKAS do not have the criteria for the firms to disclose their IC. Most of these information lies outside of the financial statements. As a result, stakeholders are not receiving the full picture of a company's value from the financial statements alone.

Intangible assets are complicated to be recognized in companies' statement of financial position under the current accounting and reporting framework. Therefore, companies tend to report these resources voluntarily in their annual reports (or on websites) (Yi & Davey 2010). As far as IC is concerned, the disclosures of IC are generally related to those in the guidelines of G3.1 or G4 as per Global Reporting Initiative (GRI)(Senaratne, Ajward & Liyanapathirana 2015). These guidelines are generally considered as representing current best practice reporting on sustainability.

Problem identification

As per the annual report of Board of Investment [BOI] of Sri Lanka (2000) and the Intellectual Property Act 1979 and No. 40, 2000, Sri Lanka is now moving towards a KBE. Still, there is no legislative guideline provided for ICD in Sri Lanka(Kehelwalatenna & Gunaratne 2010).

It is often argued that firms' spending on their employees is recognized as an expense in the statement of comprehensive income in the current financial accounting and reporting. Various accounting researchers are debating this accounting treatment by arguing employees are claimed as the real value creators of IC in firms (Vithana 2014).

In Sri Lanka, companies are investing considerable amounts in training its employees. These substantial investments to train and retrain quality staff are not reflected in the statement of financial position of these companies in various industries. It is also due to strict recognition criteria for IAs that do not allow human capital to be shown as an asset in the statement of financial position (Abeysekera & Guthrie 2005, Agne & Maria 2014, Abhayawansa & Guthrie 2014). Jayasooriya, Gunawardana and Weerakoon Banda (2015) state that

> _[t]he different practices of disclosing the IC in annual reports do not result in the real financial position of the firm, is a key problem in Sri Lankan business organizations.'

Research question

In order to address the problem identification, the following research question needs to be answered.
How public listed companies disclose IC information in annual reports?

Objectives of the study

Based on the literature review, this paper sets out to achieve the following objectives:

- to examine the nature of disclosing the IC information based on the companies'annual reports
- to reveal the significant findings of past Sri Lankan ICD research studies.

This research contributes to limited research in the context of Sri Lanka since past research repeatedly concerning on developed economies. The remainder of this paper is structured as follows. First, the literature on ICD is reviewed. Next, research methods are detailed. The following section discussed the findings of the study. Finally, conclusions are given.

Review of literature

The relationship between IC and Integrated Reporting (IR)

From the stand of literature, it has been acknowledged that capital market actors consider IC information is essential and useful for making an investment, stock recommendation and portfolio selection decisions

(Abhayawansa & Guthrie 2010). Previous studies state that companies typically disclose little information of IC, and express that companies‘ reports contain ICD of poor quality (Guthrie & Petty 2000) that were inadequate to satisfy the stakeholders‘ needs (Guthrie & Petty 2000, Abhayawansa & Guthrie 2010).

Some initiatives have been developed in the most recent years to improve current reporting on IC, though, none of them stresses the importance to provide IC in an integrated way with financial information. A prominent exception is an effort initiated by the International Integrated Reporting Council (IIRC)[1] In developing its framework (Abhayawansa 2013). The IIRC aims at overcoming the limitations of annual reporting and sustainability reporting to enable companies to the real picture of value creation with a core emphasis on IC. On the contrary with other forms of corporate IC Reporting (ICR), the prime objective of IR is to supplement information embedded in conventional financial statements with IC information to shed light on the value creation processes by the companies (Dumay & Cai 2014). According to Abhayawansa (2013), the ICR frameworks were driven by an assumed demand for IC information from capital market actors. Thus, they were designed to address the information needs of users of corporate information that were not met by traditional financial statements.

The International Integrated Reporting Framework (IIRF) (2013) defines, IR as ‗a clear and concise representation of how a company creates value over time aiming to provide insights about the resources and relationships used and affected by a company.' The IIRF categorizes six types of capital, such as financial, manufactured, intellectual, human, social and relationship and natural. The IIRF covers three categories of IC in terms of structural capital, relational capital and human capital. IIRC (2013, p. 4) clearly states that when these types of capital were material to the company‘s ability to create value for itself, they should be included in the IR.

[1]The IR framework was issued by IIRC to explain the fundamental concepts, principles and content requirements underlying an IR which is considered as a new evolution of corporate reporting. In 2011, IIRC published IR discussion titled ‗Towards Integrated Reporting: Communicating Value in the 21st Century and IIRC Pilot Programme for IR is launched. In 2012, the development of the framework draft was released. In 2013, a Consultation Draft of the Framework was released.

Definitions and elements of IC

The term intangible asset is used in accounting literature, knowledge asset is used in the economics literature, and the term IC seems to have originated from human resource literature (Lev 2001). According to the available literature on IC, some different definitions of IC can be seen. For example, Sveiby‘s definition of IC in 1997b refers that it consists of invisible assets of a company, which include: internal structure, external structure, and employee competence. Sullivan's definition in 1999 (cited in Yi 2012, p. 20) refers that IC is the knowledge that can be converted into profits. It consists of two elements: human capital and intellectual assets. Similarly, Sharma et al. in 2007 (cited in Yi 2012, p. 20) IC refers to the knowledge, skills, and technologies applied to create a competitive edge for a company. According to Sveiby (1997b), employee competence represents the employees' capacity to act in different situations, the internal structure represents everything created by employees that is generally owned by the company, and external structure represents a company‘s relationship with external parties like customers and suppliers.

Few significant studies on IC have adopted Sveiby's three categorizations of employee, internal, and external capital, with different ways of interpreting each of the categories (Choong 2008). With reference to Guthrie and Petty (2000), IC was one of the most prominent that has adopted Sveiby's framework. However, Guthrie and Petty (2000) modify Sveiby's framework from a structure based IC into capital based IC, which means all IC items were classified into three groups of capital, namely internal capital (instead of internal structure), external capital (instead of external structure), and human capital (instead of employee competence). This framework was then adopted by more recent IC studies like Guthrie, Petty, and Ricceri (2006), Abeysekera (2007) and Yi and Davey (2010). Choong (2008) stated that IC could be described as the difference between a company‘s market value and its book value. The gap between market value and book value has been studied by various researchers as the hidden value that was ignored by conventional financial reporting (for example, Guthrie & Petty 2000, Abeysekera & Guthrie 2005, Yi 2012). Market value is calculated based on an estimation of what the buyer would pay to a seller for any piece of property, while book value is the shareholders‘ equity shown in the statement of financial position, which is a reflection of the company‘s assets, less liabilities (Cheng et al. 2008).

It has been argued, though, that if IC was considered to be the unaccounted capital that influences companies' market values, then if a company's market share decreases, the company's IC should reduce (Abeysekera 2008b). It describes that IC does not essentially increase a company's value, whereas any company's asset was expected to bring future economic benefits to the company. Consequently, it could be arguable whether or not to include the term value creation in the definition of IC, as it does not meet the definition of IC value creation as provided (Mouritsen, Larsen & Bukh 2001).

In an accounting perspective, as per the standard of LKAS 38, it can be considered as the components of IC, there are ongoing debates, with the aim of arriving at the exact definition for IC. As it is difficult to come up with an exact definition on IC, which everyone will agree, the literature on the categorization of IC. Mention and Bontis (2013) classified knowledge, skills, experiences, and abilities of the members of a company as human capital. The infrastructure that encourages the human resource to create and leverage its knowledge is as structural capital. It has the ability of a company to interact with a wide range of external stakeholders (such as customers, suppliers, competitors, trade and industry associations) as well as the knowledge embedded in these relationships as relational capital.

As far as the ICD is concerned, from the available literature, internal capital disclosure refers to the disclosure of knowledge embedded in organizational structures and processes, and included patents, research and development, and systems in the companies‘ annual reports. External capital disclosure refers to the disclosure of knowledge embedded in the organizational relationship with customers, suppliers, stakeholders, and strategic alliance partners in the companies‘ annual reports. Human capital disclosure refers to the disclosure of knowledge employees take with upon leaving a company, such as knowledge, skills, experiences, abilities, motivation, and tasks in the companies' annual reports (Abeysekera & Guthrie 2005, Abeysekera 2007, Malwara Arachchi & Kehelwalatenna 2011). The literature focusing on elements of IC has been in the increasing trend (Abeysekera & Guthrie 2005, Abeysekera 2007, Yi & Davey 2010, Malwara Arachchi & Kehelwalatenna 2011). Unfortunately, the literature was yet to develop a universally accepted definition of IC (Choong 2008) or even its elements (Husin, Hooper & Olesen 2012).

Recently, Jayasooriya, Gunawardana and Weerakoon Banda (2015) analyzed the current practices of IC among listed companies on CSE over the period of three years from 2012 to 2014 based on the content analysis of 270 annual reports of 30 companies. Sample companies were selected based on a stratified random sampling method. The authors found that in terms of HCD, most of the companies have not touched the HC information in their annual reports. Only the salaries and provision for gratuity were taken into account. Bank, finance, and insurance sector companies and the plantation sector companies disclosed the HC information in their annual reports. Out of the sample companies, only 22 companies reported the HC information. In terms of organizational capital, they found that most of the companies disclosed the information concerning the organizational system under the sections of management discussion and analysis and organizational risk management. Bank, finance, and insurance sector companies and the diversified holdings companies have reported the information about their organizational capital. Out of the sample companies, only 12 companies reported the organizational capital. In terms of social capital, they found that the companies have discussed customer details, goodwill of the company and other variables. Out of the sample companies, only 13 companies reported the social capital.

Status of the Disclosure of IC information in the companies' annual reports in Sri Lanka

Sampath Bank PLC disclosed employee related measurements as:

> ‗Profit per employee LKR 1.2 million, employee retention 97% in 2014' (Sampath Bank PLC 2014, p. 34).

Dialog Axiata PLC 2014 disclosed employee welfare as:

> ‗The BOD of the bank at its meeting held on February 23, 2015, approved a proposal to introduce an ESOP for the benefit of all Executive Officers in grade 1 A and above. It happened by creating up to 2% of the ordinary voting shares at the rates specified in the proposed ESOP in 2016, 2017, 2018, upon the bank achieving specified performance target set for the years 2015, 2016 and 2017 respectively in the proposed ESOP. P.405 88,649,900 options were granted in June 2005 under Tranche 0 to eligible employees at Rs.12 each. Up to 25 October 2014, out of the total number of share options granted under Tranche 0, a total of 51,330,499 options had been exercised, and a total of 11,562,301 options had been forfeited. The employees exercised 226,800 options during the financial year' (Dialog Axiata PLC 2014, p. 110).

Union AssurancePLC disclosed training and development as:
‗Investment in training and development LKR million 49' (Union Assurance PLC, 2014, p. 9).

Hatton National Bank PLC reported its systems in detail in the following manner.

> ‗Over the past few years, the Bank has recognized technology as the key driver in implementing some of its strategies, and accordingly, has invested over LKR 1 billion to upgrade the Bank's IT platforms' (Hatton National Bank PLC 2014, p. 39).

Cargills (Ceylon)PLC disclosed customers and their relationship in the following manner:

> ‗This customer-centric focus has been further strengthened through the Cargills Member Loyalty programme which reached over

> 340000 customers. In the year ahead the Cargills Member Loyalty card will play an important part in providing a differentiated, personalized offering which is relevant and tailored to individual customers and their lifestyles' (Cargills (Ceylon) PLC 2014, p. 26).

Sampath Bank PLC disclosed employee related measurements as:

> ‗Profit per employee LKR 1.2 million, employee retention 97% in 2014' (Sampath Bank PLC 2014, p. 34).

Nestle Lanka PLC disclosed employee relations as:

> ‗One of our greatest assets is our employees. It is critical to our success to attract, retain, develop and motivate the best people with the right capabilities at all levels of operations. We review our employee policies regularly and are committed to investing in training and development. We also carry out succession planning to ensure that the future needs of the business are considered and provided. There are clear processes for understanding and responding to employees' needs through Human Resource initiatives, staff surveys and regular communication of business developments' (Nestle Lanka PLC 2014, p .22).

Methodology

IC information in terms of internal capital disclosure, external capital disclosure, and human capital disclosure was adopted as an instrument to examine the nature of ICD information by Sri Lankan listed companies. This study is employed in the content analysis of the annual reports as a qualitative research method. Companies with higher market capitalization are most likely to disclose IC information from 2011 onwards incorporating G3.1 guidelines. For instance, Union Assurance PLC has been preparing its annual reports in accordance with Integrated Reporting (IR) and GRI guidelines since 2011. Three years' annual reports from 2013 to 2015 of the top 30 companies in terms of highest market capitalization as of 10th of June 2015 were screened in terms of words, sentences, pictures, tables, and graphs. For this study, a list of ICD items has been developed by Malawara Arachchi, and the authors modified Kehelwalatenna in 2011 and used in this study. This list was classified under the category of internal capital disclosure, external capital disclosure, and human capital disclosure to analyze the nature of ICD through content analysis of the annual reports of companies.

Discussions

Content analysis of companies' annual reports was almost invariably used to measure the level of ICD. Content analysis involves codifying qualitative and quantified information into predefined categories in order to derive patterns in the presentation and reporting of information (Guthrie & Petty 2000, p. 244). An interesting point to note from the usage of content analysis is that only very few studies (Vandemaele, Vergauwen & Smith 2005) have included the graphical information in their study. All of the other studies failed to include the images (for example, Schneider & Samkin 2008, Yi & Davey 2010). Guthrie at al. (2004) argued that applying content analysis to visual images possesses its challenge, possibly more significant than when analyzing numbers.

Most of the companies are preparing their annual reports in the following headings, such as group highlights, governance, sustainability integration, and risk management, management discussion and analysis, financial statements and supplementary information. These sections generally cover the IC related information in terms of quantitative and qualitative as well.

In the context of Sri Lankan companies, in terms of ICD, there are limited numbers of research studies have been undertaken. When comparing with the previous Sri Lankan studies (for example, Abeysekara & Guthrie 2005, Abeysekara 2007, 2008, 2011a, 2011b, 2014, Kehelwalatenna & Gunaratne 2010, Jayasooriya, Malwara Arachchi & Kehelwalatenna 2011, Gunawardana and Weerakoon Banda 2015), it is acknowledged that findings of these studies provide some insights related with IC and ICD in the context of Sri Lanka. Abeysekara, who is a pioneer in the accounting research of IC and ICD in Sri Lanka, used the old dataset. There were some practical problems to use findings from these studies to generalize the ICD practices of listed companies on CSE in the current scenario. Given the weaknesses above, more comprehensive accounting research into ICD practices in listed companies on CSE is essential.

Abeysekera (2007, p. 66), highlights the differing results obtained by using a frequency count and a line count in the same annual reports of the sample companies of his study that based on a frequency count, ECD had most reported category while based on line count, HCD had a most reported category. Further, he states that the danger here is that choosing one unit over another may result in different interpretations. Malawaraarachchi and Kehelwalatenna (2014) found that IC of Commercial Bank of Ceylon PLC revealed that the component of InCD reported a higher level than HCD and ECD. It has been determined by the reporting of processes, philosophy systems, new products, and financial relations of the company. The component of HC, employee-related measurements, entrepreneurial skills and employee relations come out averagely in the annual report. Abeysekera and Guthrie (2005) found that the most frequently disclosed category was ECD, and brands and corporate image were the items of ECD. Interestingly, they found an increase in the frequency of ICD over the two-year period that they investigated. Most of the companies were qualitatively disclosed the items of internal, external and human capitals in their annual reports.

By analyzing the three-year annual reports from 2011 to 2013, Jayasooriya, Gunawardana and Weerakoon Banda (2015) found that among the 90 companies listed on CSE, 25% of companies reported HCD. Bank, finance, and insurance sector companies and the plantation sector companies disclosed the HC information. 13% of companies reported organizational capital. Bank, finance, and insurance sector companies and the diversified holdings companies have reported the information about their organizational capital. 15% of companies reported social capital. Plantation sector and diversified holdings have reported the information about their social capital.

It was found in this study that some companies were very reluctant to disclose some elements of IC in their annual reports, such as trademark, number of employees, employee equity issues, training and development, employee relation and entrepreneurial skills. Firstly, some companies might consider that the preparation of IC information would be a cost for them and consequently they would not like to disclose these elements of IC information. Also, some disclosure items of IC such as intellectual property, and the disclosure of them might be speedily imitated by competitors. It will impair the company's interests. Therefore, it is not likely for some companies to disclose on such items (Abeysekara 2007 & 2011b, Yi & Davey 2010, Yi 2012). Moreover, the dominant role of the conventional financial reporting and the lack of generally accepted ICD frameworks might also be factors discouraging some companies from disclosing the IC information in their annual reports (Abeysekara 2007, 2011a & 2011b, Malwara Arachchi & Kehelwalatenna 2011, Yi & Davey 2010).

Conclusions

Investments on staff are not reflected in the statement of financial position of the companies in various industries due to strict recognition criteria for Intangible Assets that do not allow human capital to be shown as an asset. Different practices of disclosing the IC information in annual reports do not result in the real value of the financial position of the company, is a central problem in Sri Lankan companies. Present KBE, IC has been regarded as a critical value driver for companies in achieving and sustaining a competitive edge. Because of the importance of IC, many companies, especially those publicly listed companies, have attempted to report their IC in their annual reports in order to signal their superior quality to the market as well as attract potential investors. In this study, the authors conducted a comprehensive literature review concerning ICD, especially in Sri Lanka. The findings show that there was a generally increasing trend of ICD in the

Sri Lankan listed companies. Most of the Sri Lankan listed companies are now being disclosed the IC information in their annual reports in terms of words, sentences, pictures, tables and graphs with the core discipline of GRI4 guidelines. Most of the companies were qualitatively disclosed the items of internal, external and human capitals in their annual reports. As compared from 2013 to 2015, there was generally an upward trend of the disclosure of IC items of the sample companies.

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