Impact of Intellectual Capital Disclosure Practices on the Credibility of the Financial Statements

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Abstract

Intellectual capital is the knowledge that can be exploited for money-making or other useful purposes. The term combines the idea of intellect or brain-power with the economic concept of capital. Even though there is an impact of intellectual capital disclosure practices on business performances; only the financial capital is recorded in the financial statements. It means that the credibility of the financial statements is understated. Therefore, this study aims to investigate the impact of intellectual capital disclosure practices on the credibility of the financial statements. Further, the relationship between the managerial perception of intellectual capital disclosure practices and the credibility of financial statements has been investigated. As the method, the primary data was collected through a questionnaire. The targeted sample was the financial managers who are directly involved in the preparation of financial statements in public limited companies. 150 questionnaires were distributed covering financial managers of all the sectors using the stratified random sampling method. There were three hypotheses developed covering the major components of intellectual capital as human, customer and social. Correlation analysis was done to test the hypothesis using the SPSS software. It was found that there is a relationship between the managerial perception of intellectual capital disclosure practices and the credibility of the financial statements. Through a regression analysis, it showed that there is an impact of intellectual capital disclosure practices on the credibility of financial statements. The managers believe that the existing reporting practices do not represent the reality of the organizational performance until the intellectual capital is incorporated to the financial statements. Further, they have suggested that there should be a proper mechanism to report the intellectual capital in the financial statements or in the annual reports to avoid such kind of misrepresentation.

Keywords: Intellectual Capital, Disclosure Practices, Credibility, Financial Statements

INTRODUCTION

Intellectual capital disclosure practices are one of the modern accounting practices in the field of accounting and that is a voluntary disclosure practice which is used by companies to show their strengths of intellectual capital to the stakeholders (Guthrie & Petty, 2004). The companies mostly use the annual reports to report their intellectual capital. Dzinkowski (2000) says that presently, there is no any universally acceptable definition for intellectual capital, although practitioners, business journalists and academicians have the same board set of practices in mind. At the present time, there is still room for experimentation in quantifying and reporting on the intellectual capital of an organization.

There are three capital components that can be identified in the Intellectual Capital (IC) as Human Capital (HC), Organizational Capital (OC) and Social Capital (SC). Those capitals give a considerable contribution to the wealth of the organization (Sevlby, 1997; Stewart &Ruckdeschel, 1998; Leon, 2002; Caddy, 2000) and the main problem is the subjectivity and complexity of reporting them (Svelby, 2000; Sullivan, 2000; Seetharamnan, Lock and Saravanan, 2004). Therefore, it is hard to compare and get a clear idea about the intellectual capital of the organizations. Without proper reporting of intellectual capital, the financial statements of the companies do not represent the real value of their organization. (Edvinsson, 1997; Johanson, 1999; Roslendr and Fincham, 2001). Therefore, the decisions taken by referring the figures of financial statements will be problematic without considering the strength of intellectual capital of the company (Bredker, Guthrie and Cuganensum, 2005). According to the Sri Lankan context, finding the importance of reporting the intellectual capital in the financial statements is also needed (Abeysekara and Guthrie, 2005).

Since, there is no any proper mechanism to disclose the intellectual capital in the financial statements, the credibility of the financial statements will be problematic (Han and Han, 2004;Homer, 2009; Leslie, Eyesan and Semiu, 2009). According to American Heritage Dictionary (2010) of the English Language, financial credibility is the capacity for belief the financial statements. Collins English Dictionary (2003) stipulates that the financial credibility is the quality of being believed or trusted about the financial statements. If the credibility is not available, then the comparison of financial statements will not be worthwhile and create a gray space which is questionable. But, to represent the exact resource base of the organizations and to enhance the

credibility, it is needed to develop a proper mechanism to disclose the intellectual capital in the financial statements (Zambon, 2005). Therefore, due to the improper practices of intellectual capital disclosures, the financial credibility of the financial statements is understated. This study was aimed to find the relationship between the managerial perception of intellectual capital disclosure practices and the financial credibility of the financial statements.

LITERATURE REVIEW

Intellectual capital is the knowledge that can be exploited for money-making or other useful purposes. The term combines the idea of intellect or brain-power with the economic concept of capital. The saving of entitled benefits can be invested in producing more goods and services (Guthrie, Petty and Johanson, 2001). There are three components in intellectual capital as human, organizational and social capital.

Human capital also encompasses how effectively an organization uses its people's resources as measured by creativity and innovation (Petrash, 1996; Guthrie, Petty and Johanson, 2001; Gegan and Draghici, 2013). Therefore, in this study, leadership styles, employee motivation and satisfaction, work related knowledge and competency, entrepreneurial spirit and innovativeness of the employee of the listed companies have been investigated under the human capital as a major section of intellectual capital.

Organizational capital means the knowledge flow of the structure of the organizations. It includes corporate strategies, processes, corporate culture, systems, and management credibility of the organizations (Petrash, 1996; Guthrie, Petty and Johanson, 2001; Gegan and Draghici, 2013). It is named as Structural Capital which is internal. All the internal knowledge flow raised from the organizational structure has been discussed under the organizational capital as a main section of intellectual capital.

Social capital is directly related to the external environment of the organization. It includes the customer based whole society. Quality of the product, customer satisfaction, growth of the business in the market, customer complaints and favorable contracts with the peer groups (Petrash, 1996; Guthrie, Petty and Johanson, 2001; Gegan and Draghici, 2013) have been discussed under the social capital as a major part of the intellectual capital. This social capital is also called as customer capital.

The main dependent variable of this study is the credibility of financial statements. The credibility of financial statements has very salient implications for the quality of decisions that investors can make (Leslie, Eyesan and Semiu, 2009). Therefore, financial credibility can be defined as the capacity of believing the financial statements which basically cover the reliability, relevance, comparability, quality of representation and the risk of the financial statements (Han and Han, 2004; Homer, 2009).

Resource Dependence Theory (RDT) was the main theory which is used in the study. RDT is the study of how the external resources of organizations affect the behavior of the organization. Therefore, this covers all the variables of IC disclosures and RDT fits to this study. The procurement of external resources is an important tenet of both the strategic and tactical management of any company. The core of this theory was linked to the operationalization of variables.

Current Knowledge

It has been mentioned the evolution of intellectual capital reporting practices in the organizations and early research projects have tried to develop guidelines and accounting standards for intellectual capital. (Nerdrum and Erikson, 2001; Lim and Dallimore, 2004; Dumay, 2014). Considering the direct impact of organizational resources on the performance of the company is the key concept of being successes in the business field. The resources-based theory has contributed a lot in this field specially how to allocate the intangibles in measuring organizational performances. (Barney, 1996; Barney, Ketchen and Wright, 2011). But, the suggested findings were not much string enough to report them. Still there is no any method applied by the organizations. This study is aimed to analyze the implementation issues of reporting the suggested IC measurements by the said researchers.

As evident by number of researchers, Campbell and Rahman (2010) have suggested that the common categories and dimensions for reporting the intellectual capital covering the major three areas as human capital, customer capital and organizational capital. Striukova, Unerman and Guthrie, J (2008) have done a research on the topic “Corporate reporting of intellectual capital: Evidence from UK companies”. It stated that the disclosures of the IC using a content analysis.

That was also not covered the valuation and measurement of them. These common variables have been introduced by the said scholars to represents the IC. Therefore, these variables have been taken in to account to do this study. Kannan (2008) has done a broad literature survey. The literature survey included financial and accounting measurement techniques, perceptual measures, process and systems measures, social networks analysis techniques, and econometric techniques for intangibles measurement. It is discussed in detail about the seminal studies and popular frameworks for intellectual capital measurement. But, that was also not finalized to introduce a proper mechanism to measure the intellectual capital. The argument of this study is totally lined to the findings of the said research study. Therefore, it has been shown that there should be further studies to address the common issue with regard to finding a common procedure to report IC.

Brennan and Connell (2007) have done a prior research analysis on intellectual capital. As evident, both theoretical and empirical studies have been undertaken on intellectual capital in recent years. Early research focused on defining intellectual capital and on methods of classification (Brooking, 1996; Edvinsson and Malone, 1997; Sveiby, 1997; Roos et al., 1997; Nash, 1998). Proposed different frameworks for classifying intellectual capital are there in the recent history of IC. These frameworks are broadly similar, But, show different interrelationships among the elements of intellectual capital (Kaplan and Norton 1996; Sveiby 1997; and Edvinsson and Malone, 1997; Petty and Guthrie, 2008).

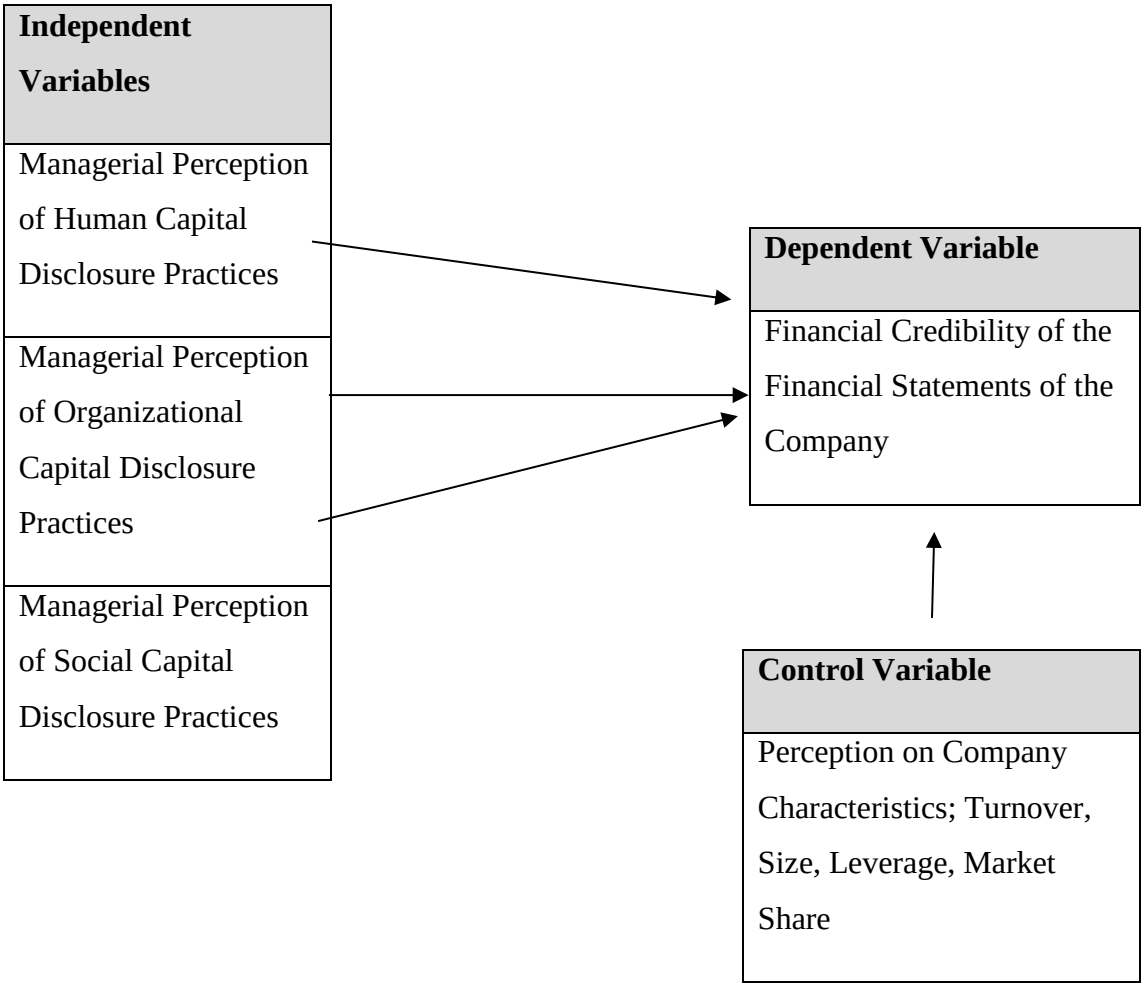
By reviewing the literature, the gap can be identified clearly. The gap here is that the fulfillment of representing the total wealth of the companies in the financial statements by enhancing the financial credibility through intellectual capital disclosure practices. Otherwise the financial credibility of the companies will be understated, and the financial statements do not show the real picture of the company.

METHODOLOGY

The conceptual framework has been designed by addressing the independent and dependent variables which were mentioned in the problem and the objective of the study.

There was a controllable variable which can be affected the relationship of the independent and dependent variables. According to the conceptual framework, there are three relationships can be identified. The developed conceptual framework and hypotheses can be mentioned as follows.

Figure 3.1 – Conceptual Framework



$H1_1$: There is a relationship between Managerial perception of *Human Capital Disclosure Practices* and the *Financial Credibility of Financial Statements* of Listed Companies

$H2_1$: There is a relationship between Managerial perception of *Organizational Capital Disclosure Practices* and the *Financial Credibility of Financial Statements* of Listed Companies

H3$_1$: There is a relationship between Managerial perception of *Customer Capital Disclosure Practices* and the *Financial Credibility ofFinancial Statements* of Listed Companies

To test the hypotheses, the data collection method and the selection of sample have beenmentioned as follows.

Table 1 - Population and Sample

Method and Source	Population	Sample
Data collection Primary data through a Questionnaire (Leon, 2002)	There are around 298 public quoted companies under 20 industry sectors. All the chief managers of finance division of the above companies can be taken as the population.	Questionnaires were distributed to the chief accountant / finance managers of following selected companies. At least 50% of the companies from each industry sector were selected as the sample. For that stratified random sampling method was used. The rational for selecting the sample was to give an equal opportunity to each and every sector since all the companies of each sector have attended to report the IC.

Data analysis was done though the SPSS software. A correlation analysis was done to test the hypotheses and a regression was run to find the impact of intellectual capital disclosures on financial credibility in financial statements.

FINDINGS AND DISCUSSION

Relationship between Intellectual Capital Disclosures and Financial Credibility

Hypothesis 1

H1$_1$: There is a relationship between human capital disclosure practices and credibility of financial statements of listed companies in Sri Lanka.

Table 2- Human Capital Disclosure Practices and Credibility of Financial Statements

Control Variables			FCM
CVM	HCM	Correlation	.527
		Significance (2-tailed)	.001
		Df	147

CVM: Control Variable (Mean)

HCM: Human Capital (Mean)

FCM: Financial Credibility (Mean)

According to this, the significance is 0.001. The tested confidence level is 95%. The significance is 0.001 < 0.050. Therefore hypothesis $H1_1$ is supported and $H1_0$ is not supported. It can be concluded that there is a relationship between human capital disclosure practices and credibility of financial statements of listed companies in Sri Lanka. That means there the variables are highly correlated since the correlation is grater then 0.5. The strength of the relationship between independent and dependent variables is expressed by squaring the correlation coefficient and multiplying by 100. The resulting statistic is known as variance explained (or R^2). The correlation of 0.527 means $0.527^2 x100 = 28\%$ of the variance in dependent is "explained" or predicted by the independent variable. The reason why squaring a correlation results in a proportion of variance is a consequence of the way correlation is defined. The final answer is that the alternative hypothesis is supported with a higher correlated value which shows the strong relationship.

Hypothesis 2

$H2_1$: There is a relationship between organizational capital disclosure practices and credibility of financial statements of listed companies in Sri Lanka.

Table 3 - Organizational Capital Disclosure Practices and Credibility of Financial Statements

Control Variables			FCM
CVM	OCM	Correlation	.633
		Significance (2-tailed)	.000
		Df	147

CVM: Control Variable (Mean)

OCM: Organizational Capital (Mean)

FCM: Financial Credibility (Mean)

According to this, the significance is 0.000. The tested confidence level is 95%. The significance is 0.000 < 0.050. Therefore hypothesis $H2_1$ is supported and $H2_0$ is not supported. It can be concluded that there is a relationship between organizational capital disclosure practices and credibility of financial statements of listed companies in Sri Lanka. That means there the variables are highly correlated since the correlation is grater then 0.5. The strength of the relationship between independent and dependent variables is expressed by squaring the correlation coefficient and multiplying by 100. The resulting statistic is known as variance explained (or R^2). The correlation of 0.633 means 0.633^2x100 = 40% of the variance in dependent is "explained" or predicted by the independent variable. The reason why squaring a correlation results in a proportion of variance is a consequence of the way correlation is defined. The final answer is that the alternative hypothesis is supported with a higher correlated value which shows the strong relationship.

Hypothesis 3

$H3_1$: There is a relationship between customer capital disclosure practices and credibility of financial statements of listed companies in Sri Lanka.

Table 4 - Customer Capital Disclosure Practices and Credibility of Financial Statements

Control Variables			FCM
CVM	CCM	Correlation	.527
		Significance (2-tailed)	.001
		Df	147

CVM: Control Variable (Mean)

CCM: Customer Capital (Mean)

FCM: Financial Credibility (Mean)

According to this the significance is 0.002. The tested confidence level is 95%. The significance is 0.002 < 0.050. Therefore hypothesis $H3_1$ is supported and $H3_0$ is not supported. It can be concluded that there is a relationship between customer capital disclosure practices and credibility of financial statements of listed companies in Sri Lanka. That means there the variables are highly correlated since the correlation is grater then 0.5. The strength of the relationship between independent and dependent variables is expressed by squaring the correlation coefficient and multiplying by 100. The resulting statistic is known as variance explained (or R^2). The correlation of 0.653 means 0.653x100 = 43% of the variance in dependent is "explained" or predicted by the independent variable. The reason why squaring a correlation results in a proportion of variance is a consequence of the way correlation is defined. The final answer is that the alternative hypothesis is supported with a higher correlated value which shows the strong relationship.

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According to the given answers of the respondents for the questionnaire, a multiple regression model was developed using SPSS to find the impact of the independent variables on the dependent variable.

Table 5 - Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.760[a]	.578	.557	.43497

a. Predictors: (Constant), CVOF4, HCM, CVOF1, OCM, CVOF2, CCM, CVOF3

The "R" column represents the value of R, the multiple correlation coefficient. R can be considered to be one measure of the quality of the prediction of the dependent variable; in this case, financial credibility of financial statements. A value of 0.760, in this, indicates a good level of prediction. The "R Square" column represents the R2 value (also called the coefficient of determination), which is the proportion of variance in the dependent variable that can be explained by the independent variables (technically, it is the proportion of variation accounted for by the regression model above and beyond the mean model). The value is 0.578 that the independent variables explain 57.8% of the variability of our dependent variable, financial credibility of financial statements.

The **F**-ratio in the ANOVA tests whether the overall regression model is a good fit for the data. The table shows that the independent variables statistically significantly predict the dependent variable, **F** (7, 142) = 27.788, **p** < .05. Therefore, the regression model is a good fit of the data.

Table 6 - ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	36.802	7	5.257	27.788	.000[a]
	Residual	26.866	142	.189		
	Total	63.668	149			

a. Predictors: (Constant), CVOF4, HCM, CVOF1, OCM, CVOF2,
CCM, CVOF3b. Dependent Variable: FCM

According to the estimated model coefficients, the following model equation can be developed.

$$Predicted\ FCM = 1.020 + (0.102 \times HCM) + (0.254 \times OCM) - (0.322 \times CCM) + (0.206 \times CVOF1) - (0.034 \times CVOF1) - (0.124 \times CVOF1) + (0.023 \times CVOF1) + SE$$

FCM: Financial Credibility – Dependent Variable
HCM: Human Capital – An Independent Variable
OCM: Organizational Capital – An Independent Variable
CCM: Customer Capital – An Independent Variable
CVOF1,2,3,4: Control Variable
SE: Standard Error

Unstandardized coefficients indicate how much the dependent variable varies with an independent variable when all other independent variables are held constant. Consider the effect of HCM in this example. The unstandardized coefficient B1, for HCM is equal to 0.025 (see coefficients table). This means that for each one unit increase in HCM, there is an increase in FCM of .025.

According to the model summary, it can be stated that there is an impact of the intellectual capital disclosure practices and the credibility of financial statements. According to the given opinion of the financial managers their responses proved that there is a significance impact. All the statistical test is shown that there is an impact of the independent variables on the dependent variable significantly. Controllable variable is also adjusted to the independent variables and to the model equation according to the statistical concept and the theory. In nutshell, a multiple regression was run to predict FCM from HCM, OCM and CCM. These variables statistically significantly predicted FCM, $F\ (4,\ 145) = 40.750$, $p < .05$, $R^2 = .516$. All four variables added statistically significantly to the prediction, $p < .05$.

RECOMMENDATIONS AND CONCLUSION

It was found that there is a relationship between the managerial perception of IC disclosure practices and financial credibility of financial statements. Therefore, all the organizations should identify the relationship of that. The organizations should be able to report the IC information by using a common method. A request should be done from the ICASL or any authorized body to interfere this matter to streamline the IC reporting process.

Developing of a method will be possible if there is a space for reporting the IC in the annual reports. There will be a possibility to find the relationships or link the variables with available data. Before, identifying a common method, the companies should attend and should have an interest on reporting the IC in their annual reports. Therefore, before formulating a framework, it is better to report the IC even using a descriptive method to identify the link between the IC and credibility of financial statements. Then a common method for descriptive data should be developed. If there are details and information, it is possible to for streamlining the reporting process.

Financial credibility of financial statements is a part of the financial statements, not a part of the disclosures in the annual reports. Therefore, finding a proper method is needed. There should be a method of measuring those using numerical figures at the initial stage. For example, employee satisfaction index, customer satisfaction index, number of customer complaints, number of qualified staffs, etc can be quantified. Then those things should be reported by linking the vales of the financial statements like the customer satisfaction with sales volume, etc. There should be a

method of reporting them even in the notes of financial statements before recognizing them on the face of the financial statements. Since there is a relationship between intellectual capital disclosures and financial credibility and as well as an impact of intellectual capital disclosures on financial credibility on the financial statements, companies should attend on reporting the intellectual capital in a proper manner to enhance the credibility of financial statements.

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