THE IMPACT OF INTELLECTUAL CAPITAL DISCLOSURE ON CAPITAL MARKETS: AN OVERVIEW

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Abstract

According to GAAP, intellectual capital is the value of firms intangible assets that aren’t reflected on the balance sheet. Intellectual capital is defined in different ways: The OECD describes intellectual capital as the economic value of two categories of intangible assets of a company: (a) organizational (structural) capital and (b) human capital. Structural capital can be further disaggregated into internal and external capital (Schneider and Samkin, 2007). Roos et al. (2005) define intellectual capital as all non-monetary and non-physical resources that are fully or partly controlled by the organization and that contribute to the organizations value creation (Peng et al. 2007). Intellectual capital can be described as structural capital, relational capital and human capital. Sveiby (2004) first proposed a classification for IC into three broad areas of intangibles viz., human capital, structural capital and customer capital a classification that was later modified and extended by replacing customer capital by relational capital (Bhasin, 2008). According to Davis (2001) structural capital encompasses the hardware, software, database, systems, work processes, business models, organizational structure, patents, trademarks, trade secrets and all other codified knowledge. Relational capital is defined 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 (Starovic and Marr). It also includes the image of the image of the organization in the market, its social identity and brand equity (Mageza, 2004). Schultz (1993) define the term human capital as a key element in improving a firm assets and employee in order to increase productivity as well as to sustain competitive advantage. Human capital is the combined capabilities, knowledge, skills, experience, innovativeness and problem-solving abilities of each individual’s knowledge (Davis and Harrison, 2001). 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 employees satisfaction and performance and eventually on a firm performance (Rizvi, 2010).

Intellectual Capital Disclosure

The failure of financial statement in informing the ability of creating value of intangible asset (Lev and Zarowin, 1999), increasing the information asymmetry between the firms and the users of the financial accounting (Healy and Palepu, 2001). This information asymmetry creates inefficiency on the resources allocation process on the capital market (Li, Pike and Hainiffa, 2008). Rylander et al. (2000) reviewed the major issues of intellectual capital disclosure and summarized them as follows:

1. The information asymmetry gap is growing as the proportion of company value attributable to intangible assets increases.
2. Long term information, particularly on strategic intent and execution, was lacking from company reporting but was considered to be of particular importance to external stakeholders, especially the investors.
3. Standards and comparability relating to the disclosure of intellectual capital would remain a major issue.
4. Value creation models could provide information to complement traditional reporting required by law
(Bontis). On other hand, the European commission (2006) emphasizes two main reasons for intellectual capital reporting: 1) reporting of intellectual capital provides additional information which can be used to improve the management of the company as a whole. 2) reporting of intellectual capital complements the financial statement of the company and therefore provides a broader, more truteful image of the company. (Basta. and Bertilsson, 2009).

ICD is defined by Abeyesekera and Guthrie (2002) as a report intended to meet the information needs common to users who are unable to command the preparation of reports about ic tailored so as to satisfy, specifically all of their information needs (Gan et al.2008).

The type of intellectual capital disclosure is valuable information for investors, as it can help them reducing the uncertainty of the company's future prospect and facilitate in valuing the firm (Bukh, 2003). ICR represents an approach that can be used to measure intangible assets and describe the results of a company's knowledge-based activities (Ismail, 2008). Table 1 provides a useful framework for comparing some of intellectual capital disclosure models.

<table>
<thead>
<tr>
<th>Developed by</th>
<th>Model</th>
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<tbody>
<tr>
<td>Sveiby</td>
<td>The intangible asset monitor: monitors three overall categories: customers (external structure), people (competence) and organization (internal structure). Under each of these interdependent categories the three key areas of growth, renewal, efficiency and stability are tracked, each with its own performance indicators (Kapitula)</td>
</tr>
<tr>
<td>Kaplan and Norton</td>
<td>The balanced scorecard</td>
</tr>
<tr>
<td>Edvinsson and Malone (1997)</td>
<td>Skandia value scheme: effects four key dimensions of a business: financial focus, customer focus, process focus, and renewal and development focus. at the heart of these is human focus, which drives the whole model</td>
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</tbody>
</table>

### Intellectual Capital Disclosure and Capital Markets

It has been suggested that the capital market may be at a disadvantage in several ways if information on intellectual capital is not reported: 1) smaller shareholders may be disadvantaged, as they usually have no access to information on intangibles often shared in private meetings with larger investors (Holland, 2001). 2) insider trading might occur if managers exploit internally produced information on intangible unknown to other investors (Aboody and Lev, 2000). 3) stock market liquidity and increased demand for companies' securities is enhanced by greater disclosure on intangibles (Diamond and Verrecchia, 1997). 4) volatility and the danger of incorrect valuations of firms is increased, which leads to investors and banks placing a higher risk level on organizations. 5) coat of capital is increased, due to e.g. higher risk levels placed on companies (Lev, 2001) reporting of intellectual capital is important for capital market and external stakeholders in order to improve their understanding of the firm's competitive positions (Mouritsen, Bukh and Marr, 2006).

#### A. ICD and Information Asymmetry

The basic assumption of these relation is that firm which provide more information about their activities reduce information asymmetry in the capital markets. One stream argues that an environment of information asymmetry introduces adverse selection into the market (Diamond and Verrecchia, 1991. Handa and Linn, 1993). Welker (1995) points out that such adverse selection leads to a reluctance by uninformed investors to trade shares in order to price protect against potential losses from trading with other better informed market participants. This reluctance to trade reduces market liquidity in the firm's shares (Amihud and Mendelson, 1986, Welker, 1995, Handa and Linn, 1993). (Managena et al., 2010)

#### B. ICD and Information Stock Price

Diamond and verrecchia (199) and Easley and Ohara (2004) contend that by improving disclosure, firms enhance the liquidity for their shares thereby attracting increased demand for the shares, which increases share price (Managena et al., 2010).

#### C. ICD and Risk

The disclosure of intellectual capital is directly related to information risk because it decreases the amount of private information relative to public information, it is also directly related to information risk because it reduces uncertainty of prospective benefits generated from uncapitalized intangible assets (Hsu, Chang).
D. ICD and Efficiency

The disclosure of intellectual capital makes capital markets more efficient and reduce the cost of firm capital (lev, 2001). Disclosing information about intellectual capital investments provides investors with a more forward-looking view of the firm (Williams, 2001, Beattie and Thomason, 2007, Guthrie et al. 2007). This improves the market's understanding of a firm's value creating processes and activities as well as the economic risks attached to the firm's shares. Such understanding leads to improvements in capital market efficiency. Grojer and Johanson (1999) suggest that IC disclosure should improve capital market efficiency and contribute to better corporate governance (Abeyesekera, 2008).

E. ICD and Sock Volatility

Intellectual capital reports increase the awareness and confidence of investors in the core capabilities of the company and enables them to study invested during moments of crisis. This in turn leads to reduced volatility in the company's stock and aggregate in the overall capital market (Talukdar, 2008). Aysuso (2002) states that understanding of intellectual capital investments by capital markets reduce stock price volatility.

F. ICD and Liquidity

Since the decrease in information asymmetry increases the market liquidity, therefore intellectual capital disclosure causes the increase in market liquidity by decrease in information asymmetry.

ICD increase the transparency. Transparency reduce the cost of capital and thereby increase the market liquidity (Hearly and Palepu, 2001). Also Bloomfield and Wilks (2000) document that greater disclosure of information about the firm leads investors to trade shares at relatively higher prices, hence providing greater liquidity of the firm's shares (Managena et al., 2010).

G. ICD and Cost of Capital

Botosan (2006) point out that greater disclosure results in a reduction of the estimation risk associated with investors' assessments of a firm's share of pay off distribution (Managena et al., 2010) the logic is that because investors estimate the parameters of return on a firm's share on the basis of available information, an increase in disclosure allows investors to better estimate share returns. According to lev (2001) the reporting of intellectual capital should reduce the cost of capital. Overall, firms improving their disclosure of intellectual capital information can lower their costs of capital by reducing information asymmetry and lowering information risk (Managena et al., 2010). Finally, ICD increase the transparency that decrease the cost of capital in capital markets.

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