

INTELLECTUAL CAPITAL REPORTING: EVIDENCE FROM THE BANKING INDUSTRY IN SRI LANKA

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ABSTRACT

Intellectual capital (IC) is recognized as a strategic asset which gives competitive advantages by driving organizations for superior performance in the modern day knowledge-based economies. Arguably, the selection of IC reporting as the phenomenon for the study was mainly due to its high sensitiveness for the business excellence in the knowledge-based economy. The objectives of the study are to explore the extent of IC reporting and recent developments in IC reporting of selected commercial banks in Sri Lanka. The study is based on data drawn from five firms in the banking industry namely, Commercial Bank Ceylon Plc, Hatton National Bank Plc, Bank of Ceylon, Sampath Bank Plc and People's Bank for the period of 2006 to 2009. The data for the study has been collected from published annual reports of the selected firms and analyzed using the developed IC reporting index for the study based on Pablos (2002) and Abeysekera (2007). Findings of the study show that there are different levels in IC reporting of selected firms, and concludes that there is no discernible pattern in IC reporting in case organizations over the time horizon selected for the study. The study contributes to the IC literature by providing evidence for IC reporting in the context of an Asian organizational setting as summons in Pablos (2002). Moreover, the findings enable organizations in Sri Lanka to evaluate their level of IC reporting though the generalizability of findings of this study to other organizations is restricted by the approach to this study.

Key words: Intellectual capital, Intellectual capital reporting, Licensed Commercial Banks, Sri Lanka

1. INTRODUCTION

Traditionally, in Sri Lanka the economic activities were aligned focusing on the agricultural activities in the economy. Later in 1940's the above-stated focus has been shifted towards the industrial sector in reflection to the industrial revolution. However, since the beginning of 1990's the focus on industrial activities were getting diluted as a result of the development of knowledge-based resources which are recognized as strategically important. With the above-focus, according to Pablos (2002),

the traditional approaches of obtaining competitive advantage have become eroded and several latest driving forces have materialized within the last few decades. Among them, Volverda (1996) and Wiig (as cited in Pablos 2002), have identified that the globalization of business and international competition, sophisticated customers, competitors and suppliers, increased technological capabilities, shortening of product life cycles, etc. as the emerging driving forces. The inclusion of human capital and other knowledge-based resources to the

organizations' asset base recognizes the arrival of knowledge economy (Grant, as cited in Pablos 2002). Such knowledge related resources are strategically important as they are idiosyncratic. This is supported by the Resource-Based View (RBV) of the firm since it identifies intangible resources as the main drive behind the competitiveness and firm performance. As a result, the management of such assets has become important and the discipline of knowledge management in the knowledge-based economy has been developed as a distinct discipline in the modern day organizations.

In Sri Lanka, the investment on IC has been recognized in recent years and it is evident that Sri Lanka is directing towards the knowledge-based economy due to following reasons. First, according to BOI as cited in Abeysekera (2007), Sri Lankan government offers reduced corporate taxation rates and exemptions from direct and indirect taxation to both local and foreign investors. Further, in his study it is stated that, the Sri Lankan government has heavily invested in maintaining a skilled labour force and a high literacy level, which makes easier for investors to maximize their return on capital and recent amendments to the Intellectual Property Act 1979, which further drive Sri Lanka toward knowledge-based economy. According to Tayles, Pike and Sofian (2007), it has been recognized that capital market requires more information regarding corporate knowledge resources such as strategic direction, experience, management qualities etc. Therefore, the management requires identifying, measuring and communicating about these corporate resources in their annual reports. Furthermore, traditional financial reporting encourages the short-term thinking of the firms and traditional accounting system does not disclose adequate information on intangibles in financial reports. Hence, the disclosure of IC related

information may be considered as important in deriving strategic decisions for organizations which are in the knowledge-based economy. In order to provide a way out to the debate discussed in above it is imperative to measure and report IC of modern day business firms.

1.1. RESEARCH ISSUE

With the introduction of Porter's five forces model in gaining competitive advantages, the decision makers of the organization are keen on identifying resources which are uniquely available for them. This is mainly due to the fact that traditionally utilized physical resources have become diminished and the nature of non idiosyncratic. In this regard, the assets which are intangible in its existence have increasingly been recognized as strategically important. Having recognized IC as an important determinant in the success of the modern day business firms, it is important to identify the drivers which best describes and measures the impact of IC (Pedrini, 2007). In line with this adventure the discipline of IC emerged and advocates of IC have included knowledge-related intangible assets which are strategically important in managing the intense competition in the market place. Moreover, the investors of modern day organizations are attempting to invest on IC resources. Therefore, the disclosures of such IC related information have gained the recognition. In line with these disclosures, the information on IC resources in the context of European, developed nations are frequent. According to Pablos (2002) it concludes that though managers of Asia and Middle East are very interested in knowledge management and IC measuring and reporting in Europe, currently they are not working on these issues. Furthermore, Abeysekera (2007) has discovered that in developing nations there can be seen an absence in IC reporting studies that have

been carried out. In addition in Pablos (2002) further evidence is called upon on IC reporting from Asia region. Therefore, this study attempts to understand the current status of IC disclosures in the context of Sri Lanka.

1.2 RESEARCH OBJECTIVES

Based on the above-stated research issue, following two research objectives have been derived;

- To explore the extent of IC reporting practices in selected commercial banks in Sri Lanka.
- To identify the trend in IC reporting practices between years 2006 to 2009 in selected commercial banks in Sri Lanka.

2. LITERATURE REVIEW

According to the Resource Based View, IC resources are recognized as strategic assets and it also can be considered as a subset of the broad set of organizational resources. The consultation of extant IC literature shows that the availability of several definitions for IC and its components. Stewart as cited in Bontis (1998), defines IC as “the intellectual material – knowledge, information, intellectual property, experience – that can be put to use to create wealth” (p. 65). The review of literature also shows that the word “knowledge” is commonly used by most scholars as the definition for IC in their studies. Therefore, following the same vein the researchers intend to define the concept of IC in this study as “knowledge related intangible assets that create value to the organization”. When considering the components of IC Abeysekera, 2008 and Guthrie and Petty, 2000 have identified Internal Capital, External Capital (EC) and Human Capital (HC). Further, in identifying IC components researchers have been considered number of elements to have a greater

understanding on each component and same as the disagreement on components of IC, the literature review on elements of IC too expose the same pattern. These elements differ from one scenario to another due to the factors such as social, cultural, political, and technological, etc.

According to Pablos (2005), HC represents the knowledge, experience and skills of the employees of the firm, and commitment and motivation of the employees attributable to their continuance in the firm. Moreover, according to Harris (2000) HC is unique values of individuals considered as an asset to the organization which result in increasing the performance and creating a competitive advantage to the organization in the competitive market. Furthermore, in defining HC, elements of HC have been considering as pillars in most definitions. According to Pablos (2002), elements of HC stand as employee profile, staff turnover, education, commitment and motivation, and training and results. Abeysekera (2007) includes training and development, entrepreneurial skills, equity issues, employee safety, employee relations, employee welfare, and employee-related measurement.

Furthermore, Pablos (2005) refers to internal capital as “firm’s supportive structures for knowledge creation and deployment as well as the set of knowledge, skills and abilities embedded in the organizational structure” p.142. According to Pablos (2002) the elements of internal capital are, infrastructure, customer support, administrative process, innovation, quality improvements and knowledge-based infrastructure. In addition, Abeysekera (2007) identified the elements of internal capital as, processes, systems, philosophy and culture, intellectual property, and financial relations.

Pablos (2005) has described the EC as “organizational value that emerges not only from a firm’s relations and connections with customers,

but also with current and potential suppliers, shareholders, other agents and the society in general” p.142. Moreover, Pablos (2002) has recognized the elements of EC as, client profile, customer image and stakeholders, diffusion and networking, and intensity, collaboration and connectivity. Abeysekera (2007) has clustered the EC as, brand building, corporate image building, business partnering, distribution channels and market share.

2.1. IMPORTANCE OF IC AND IC REPORTING

Importance of the IC is acknowledged by Harrison and Sullivan (as cited in Pablos 2002), as it generates more profits, strategic positioning (market value, leadership, name recognition, etc), acquisition of innovations from other firms, customer loyalty, cost reduction, improved productivity to the firm. Further, IC gives competitive advantage to the organization within the market place since it possesses knowledge and experience, professional knowledge and skill, good relationships and technological capacities (CIMA, as cited in Tayles et al., 2007).

Further, according to the Bontis (1998) the growth of the professional service industry and the new knowledge-based firms replicates the importance of IC reporting. The reporting of IC is important for various reasons. Internal users especially managers need information to manage organizational performance more effectively; External users mainly investors need information to link to stock market valuation. Moreover, Tayles et al. (2007) argued that IC disclosures reduce transaction cost and uncertainty among relevant parties.

2.2. IC REPORTING PRACTICES

The development of IC reporting can be traced back to the aspiration of individuals who were

external and internal to the organization who concerned the true business value of the company as it is important to manage and make strategic Decisions. According to Guthrie and Petty (2000) in early 1990's there were small number of firms which disclosed IC in their annual reports. Due to the absence of proper framework or standard for IC and IC reporting, IC reports are different from one context to another. According to Pablos (2002) main purpose of IC statement is to give clear picture of the corporate effort to build up, develop and streamline its resources and competencies in relation to employees, customers, technology and processes. In this respect, Abeysekera (2007) provides a foundation to develop a framework to be used in this study through assessment criteria used in assessing IC reports. Moreover, the researcher has attempted to develop a new framework for this study (which is shown in Table 1) based on the basic pillars in the above study, and by incorporating suitable components, elements and indicators from relatively similar studies carried out in the field.

3. METHODOLOGY

3.1 SAMPLING PROCEDURE AND COLLECTION OF DATA

In the process of identifying IC reporting practices, the researchers concentrated on audited annual reports of organizations as it gives a unique pattern of reporting. Further, within the Sri Lankan context, service sector has continued to provide a contribution of 57 per cent to the growth of the country (Annual Report of Central Bank Sri Lanka, 2009). According to the Central Bank of Sri Lanka (2009), financial institutions comprise of several institutions namely, Banking Institutions, Other Deposit Taking Financial Institutions, Other Specialized Financial Institutions, and Contractual Savings Institutions. Among them banking sector

plays a significant role as it possesses more than 56 per cent of financial system assets. At the same time the banking industry which is one of the sub-sectors in the service sector is a key performing sector in the service sector (Annual Report of Central Bank Sri Lanka, 2009). Further, according to the Central bank of Sri Lanka (2009), there are two categories of banking institutions namely, Licensed Commercial Banks (LCBs) and Licensed Specialized Banks (LSBs). Among these categories, LCBs play a significant role within the Sri Lankan financial market as it holds more than 44 per cent of financial system assets (Annual Report of Central Bank Sri Lanka, 2009). Therefore, LCBs have been selected as the initial sample for the study. According to the Institute of Chartered Accountants of Sri Lanka (ICASL), Commercial Bank of Ceylon Public Limited Company (CBC Plc), Hatton National Bank Public Limited Company (HNB Plc), Bank of Ceylon (BOC), Sampath Bank Public Limited Company (SB Plc) and People's Bank (PB) have been recognized and ranked as five best institutions in Annual Report Awards Competition for the financial year of 2009 in the banking sector. Therefore, for the purpose of carrying out this study the researchers have selected the sample as CBC Plc, HNB Plc, BOC, SB Plc and PB. As IC is an emerging concept, to carry out this study recently concluded financial years such as 2006, 2007, 2008 and 2009 annual reports have been selected. The data which facilitates the data analysis has been collected using the IC framework developed under the previous section. In order to collect the identified data for the study, the researchers used secondary data source since the study is focused on analyzing IC reporting practices. In this respect annual reports of the

selected companies have been used as the data source. According to Guthrie, Petty, Yongvanich and Ricceri (2004) most of the research investigations that are based on IC related data use annual reports as the representative measure of publicly available IC information.

4. DATA PRESENTATION AND ANALYSIS

Firstly, the content analysis of annual reports has been employed for each annual report by using a numerical coding scheme namely the Likert Scale. The following table provides a summary of the numerical coding scheme that has been used in conducting the data analysis. In the process of data analysis, the collected data/information on each element of IC has been coded with the numerical coding scheme discussed in above. Afterwards the average value of data/information of IC has been taken as the value of each element. Further, the average values of elements are used in deriving the value of IC components. Finally the average values of each component are used in identifying the value of IC. Eventually, the analyzed data is presented by five cases such as CBC Plc, HNB Plc, BOC, SB Plc and PB. There, the important findings of the analysis are presented with the aim of identifying the current disclosure practice and the trend of IC disclosure of each case organization.

4.1 CASE ONE - CBC PLC

CBC Plc is a leading private sector Sri Lankan bank incorporated on June 25, 1969. At the moment it is operated with a wide network of branches and Automated Teller Machines (ATM) not only in Sri Lanka but also across the world with a consistent and solid financial performance

Table 01: IC reporting framework

IC Components	Elements	Indicators
Human capital	Training and Development	Know-how Training programs Career development plans Vocational qualification
	Entrepreneurial Skills Equity issues	Innovations Equity issues relating to race Gender (male ,female) Religion Disability
	Employee safety Employee relation	Working environment Union activities Employees being thanked Employees being feature Employee involvement in the community
	Employee welfare	Employee and executive compensation plans Employee benefits Employee share and option ownership plans
	Employee related measurements	Value added by employees and executives Employee numbers Professional experience Educational level Expert seniority Age of employees
	Staff turn over	Circulation % of personnel Resigned Beginners
	Internal Capital	Processes
Systems		Information systems Net work systems
Philosophy and culture		Management philosophy Management culture
Intellectual property		Patents Copy rights Trademarks
Financial relation		Favorable and unfavorable financial relations
External capital	Brand building	Brands Customers Customer satisfaction Quality standards Relational marketing
	Corporate image building	Company name Favourable contracts New stake holders Relationship with other stakeholders Business collaboration
	Business partnering	Licensing agreements Franchising agreements Number of distribution channels held
	Distribution Channels	% market share held by firm
	Market Share	

Source: Adapted from Abeysekera (2007) and Pablos (2002)

Table 02: Summary of the numerical coding scheme

Code / score	Description
1	Item did not appear in the annual report
2	Item appeared in annual report at a low level
3	Item appeared in annual report at an average level
4	Item appeared in annual report at a high level
5	Item appeared in annual report at an excellent level

Source: Collis and Hussey (2003)

Table 03: Summary of level of IC reporting in CBC Plc

	CBC Plc Mean Scores			
	2006	2007	2008	2009
Intellectual Capital	2.88	2.92	3.02	3.01
Human Capital	2.56	2.68	2.94	2.67
Internal Capital	3.5	3.5	3.5	3.5
External Capital	2.59	2.59	2.63	2.85

According to the analysis, IC reporting of CBC Plc indicates an average level throughout the considering years and its position on IC reporting has been enhanced slightly from 2006 to 2008 and then slightly reduced in 2009. When considering the composition of IC reporting, the component of internal capital demonstrates a higher level of reporting than the other two elements namely HC and EC. This has been driven by the reporting of processes, systems, philosophy and culture, and financial relations of the company. Under the component of HC, employee related measurements, entrepreneurial skills and employee relations appeared averagely in the annual report. Further, within those elements age analysis, expert seniority and employees being thanked were reported with a higher level of recognition. However, indicators such as value added by employees and executives to the organization, and employees being featured had not appeared at all. Nevertheless, CBC Plc has enhanced the reporting on HC slightly during the four years considered. In addition to this, it also has maintained a knowledge management report under which it specifically mentioned about Knowledge Capital (KC) which is sub-divided in to two categories namely human capital and structural capital. According to annual report of CBC Plc

(2006), “KC consists of the intangibles of the company: customer relationships, business practice, know how, technical infrastructure corporate culture, work ethics and other soft factors that create value” (p.76). Further, annual report of CBC Plc (2006) define “HC or walking capital consists of skills and experience of employees and management, business routines, work ethics and organizational culture and factors that leave every day when employee and manager step out of the skills, capabilities, attitudes, mindsets and emotions of employee and manager” (p.76). Moreover, annual report of CBC Plc (2006) identified that “structural capital consists of those intangible assets that are relatively fixed to the organization and include company software, databases, brands, customers, patents, product portfolios and organizational memory” (p.76). However, this knowledge management report has not appeared in the 2009 annual report.

4.2 CASE TWO - HNB PLC

The roots of HNB can be traced back to 1888, year of its inception. Presently, it operates with an intent to be the acknowledge leader and chosen partner by means of providing diverse set of services incorporate banking , personal banking,