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Accounting for Intellectual Capital and Financial Reporting Quality of Listed Manufacturing Firms in Nigeria

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ABSTRACT: *This study investigated the extent to which intellectual coefficient (IC) in human resource (HR) accounting relates with the quality of financial reports. IC was assessed with litigation risk.The research design employed in this study is the ex-post facto research design. Purposive sampling technique was adopted to sample 14 firms with up to date and complete annual reports and accounts for the study period (2017-2021). Secondary data derived from the financial statements of companies were reviewed for the study. Descriptive statistics was used to summarize the mean, median, standard deviation, skewedness, kurtosis, maximum and minimum of the study variables, while panel regression was used to test the null hypotheses. Findings of the study revealed that intellectual capital has a negative relationship with litigation risk and IC has positive relationship with financial reporting quality. It is recommended that companies should on creating relational awareness in their employees through adequate training in the aspect of customer relation and proper management of financial and human resources.*

KEYWORDS: Intellectual capital, VAIC, human capital efficiency, earnings management, human resource accounting

INTRODUCTION

The Information age has ushered the global economy into the knowledge economy. The knowledge economy is focused on the essential importance of human capital in the 21st-century economy. The knowledge economy (or the knowledge-based economy) is an economic system in which the production of goods and services is based principally on knowledge-intensive activities that contribute to advancement in technical and scientific innovation (Powell & Snellman, 2020). It is an economic system based on the consumption and production of intellectual capital. In particular, it refers to the ability to capitalize on scientific discoveries and basic and applied research by humans. In a knowledge economy, a significant component of value thus, consist of intangible assets such as the value of its workers' knowledge or intellectual

property (Hayes, 2020). Intellectual capital(IC) is viewed as intellectual material, knowledge information, intellectual property and experience that can be put to use to create wealth (Stewart, 1997). Intellectual capital has also been defined as the ideas or understanding which an entity possesses that is used to take effective action to achieve the entity's goals (Justin et al., 2021). Intellectual capital (IC) covers three main areas which are; Human Capital (HC), Structural Capital (SC), and Relational Capital (RC) (Okoye, et al, 2015). The branch of accounting that deals with employees' emoluments is called human resource accounting.

The analysis of human capital efficiency consists in evaluating whether conducted human capital development activities contribute to achieving the aims or to the improvement of given results. Since human capital is viewed as having an impact on financing, efficiency becomes the relevant issue in determining the value relevance of human capital. Human Capital Efficiency measures the value added by the Human Resources of an organization. Value Added Intellectual Coefficient (VAIC) is a method used to measure the value creation Efficiency of a company by using its accounting based figures (Pulic, 2000). VAIC is based on the relationship of three major components: Human Capital Efficiency (HCE), Structural Capital Efficiency (SCE) and Capital Employed Efficiency (CEE).

Human resource accounting has been of paramount importance which demonstrates that it has significant effect or relationship with quality of financial reporting for different stakeholders. International Accounting Standards Board (IASB) (2100) defines financial reporting as representing financial statements that provide accurate and fair information about the underlying financial position and economic performance of an entity. Financial reporting entails the recording of financial information according to relevant accounting standards. According to Akintoye (2012), financial reporting quality includes the exposure of related financial information to the different Stakeholders about an organization over a pre-defined timeframe. These Stakeholders include – investors, lenders, suppliers, and government organizations". Financial reporting is considered as the final result of Accounting. It comprises of various important statements which include - financial related explanations from Statement of financial position, Statement of comprehensive income.

According to Choi and Pae, (2011), quality financial report is very important for the company. Therefore, differences in managerial reports lead to conflict between managers and shareholders due to the emergence of information asymmetry. This also gives rise to errors, thereby leading to litigation, which is one of the external factors that hinder managers in carrying out their duties. Juanda (2006) stated that investors and creditors need to file lawsuits against companies when fighting for their rights and interests. Litigation occurs when the existing legal and regulatory practice does not include accounting practices and also arises when transparent information is not provided by management.

Chrisnoventie (2012) stated that litigation risk is an inherent uncertainty in a company due to stakeholder can harm the company. Management behaviour is also affected by the risks associated with litigation which makes management seek for the ways to convince the funder to continue investing in the company. This is often achieved by polishing the reports produced by the company to appear good to the reader which ultimately leads to manipulations with accounting data and information. Litigation risk is an external factor, so managers tend to avoid the possibility of litigation risks that harm the company. It tends to occur when accounting practices conducted by a company go against the existing laws and regulations (Juanda, 2006). With the success of managers to avoid litigation risk, investors' interests will eventually be protected and investors can develop stock markets, equity, ownership structures, and dividend policies (Leuz et al., 2002; Hodge 2013). When investors buy stock, they automatically obtain certainty of right or obligation that is protected by the law.

Statement of the problem

The accounting aspect of the human capital is yet to be fully accepted and applied in the corporate financial reports of corporate entities. This raises many questions relative to the quality and relevance of the financial reports prepared and published by corporate entities especially listed companies in Nigeria.

According to Bader (2017), it is still unclear whether intellectual capital is reported or under reported by listed companies and if this might undercut investor confidence in any way. Furthermore, it is also apparent that human capital disclosures may vary from one firm to the other even in the same industry and the value relevance of HCA disclosures are yet to be ascertained by investors. Such information may boost investor confidence, but where it is not available; making investment decisions in the information economy becomes a problem, because people want to know how companies value their employees and how creative they are. Many studies have however been done on measurement and value creation in human capital accounting. However, their findings are mixed and were mostly not reflective of value added intellectual coefficient (VAIC).

Objectives of the study

The main objective of this study was to examine the extent to which value added intellectual coefficient in HR accounting relates with the quality of financial reports. Specifically, the study seeks to;

i. Examine the relationship between Human Capital Efficiency (HCE) and litigation risk of listed manufacturing firms in the Nigerian Exchange group (NGX)
ii. Ascertain the moderating effect of litigation risk on the relationship between Human Capital Efficiency (HCE) and the quality of financial reports of listed manufacturing firms in the Nigerian Exchange group (NGX).

Research questions

The following research questions are stated for the study

i. What is the relationship between Human Capital Efficiency (HCE) and litigation risk of listed manufacturing firms in the Nigerian Exchange group?
ii. What is the moderating effect of litigation risk on the relationship between Human Capital Efficiency (SCE) and the quality of financial reports of listed manufacturing firms in the Nigerian Exchange group (NGX?

Research hypotheses

The following research hypotheses are stated to guide the study

H_{01}: There is no significant relationship between Human Capital Efficiency (HCE) and litigation risk of listed manufacturing firms in the Nigerian Exchange group.

H_{02}: There is no significant moderating effect of litigation risk on the relationship between Human Capital Efficiency (SCE) and the quality of financial reports of listed manufacturing firms in the Nigerian Exchange group (NGX.

LITERATURE REVIEW

Financial reporting quality

Financial reporting is the preparation of published report for users of financial statements. Financial reporting is the process of documenting and communicating financial activities and performance over specific time periods, typically on a quarterly or yearly basis. Companies use financial reports to organize accounting data and report on current financial status (Oliver, 2021). Financial reporting uses financial statements to disclose financial data that indicates the financial health of a company over during a specific period of time. The information is vital for management to make decisions about the company's future and provides information to capital providers like creditors and investors about the profitability and financial stability of the company. Financial statements provide essential financial information that helps investors, creditors and analysts evaluate a company's financial performance (Herath & Albarqi, 2017).

According to the International Accounting Standards Board (IASB)(2010), financial reporting quality represents financial statements that provide accurate and fair information about the underlying financial position and economic performance of an entity. Financial reporting quality is defined as the financial disclosure statements that will disclose the financial status in the annual report and strengthen the investors' confidence in making credible decisions about their organizations. The chief objectives of financial reporting is to portray the position and performance of the entity in question so that investors in equity and debt, among other stakeholders, can make credible and economic decisions based on accurate information regarding potential risks and returns (Deloitte, 2012; FRCN, 2015). Financial reporting is considered as being of high quality if it possesses three attributes which include transparency, full disclosure and comparability.

Transparency is referred to as the revealing of information about events, transactions, judgment and estimates which allows users to see the result and implication of decisions, judgment and estimates of preparers. Full disclosure is related to the provision of all information necessary for decision-making while comparability means that similar transactions are accounted for in the same manner both cross- sectional arising among companies as well as over time (Barton & Waymire,2004).

Measures of financial reporting quality

There are several measurements of reporting quality FRQ (Choi and Pae, 2011; Laux, et al, 2011) because there is no generally accepted mode of measurement (Dechow et al., 2010). The first measurement that is used is degree of earnings management (EM) by using accruals, whereas the second is accruals quality and the third is degree of accounting conservatism. Earning management is considered inverse to FRQ (Dechow and Dichev, 2002); a higher the level of EM or earnings management is linked with lower quality financial information and lower level of earnings quality as well (Raman et al., 2012). Therefore, the first measurement of financial reporting (FRQ) is management choice over accruals (Choi and Pae, 2011).

Value added intellectual coefficient (VAIC)

Value Added Intellectual Coefficient VAIC indicator is a performance measurement that is assumed to be able to meet the requirements of modern economy, measuring the effectiveness of key resources in the enterprise. The VAIC method calculates both the overall efficiency of a company, and its intellectual capital efficiency (ICE). VAIC is based on two main assumptions: a) that the creation of a company's added value is based on the use of physical and intellectual capital, and b) that the added value created for a company is connected to its overall efficiency. In the model, both intellectual capital and physical capital are considered as investments. The use of a company's intellectual capital consists of its assets, the productivity of its accrued profit and its liabilities. Intellectual capital is capital that consists of the company's employees and its structure.

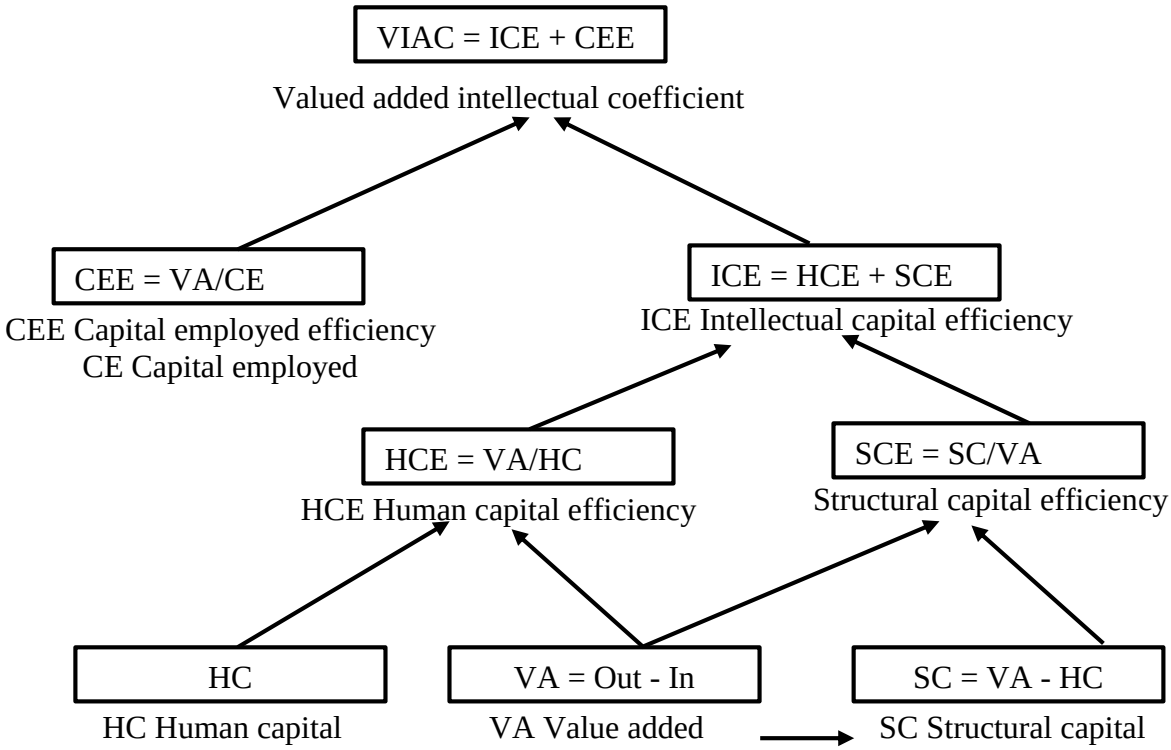

Fig. 1: Construction of the Value Added Intellectual Coefficient (Adapted from Pulic, 2002)

The VAIC method relies on the concept of value added as the measure of performance, relative to intellectual capital (Laing *et al.* 2010). It consists of the sum of three component ratios, i.e. human capital efficiency (HCE), structural capital efficiency (SCE), which embraces both internal and relational capital efficiency, and capital employed efficiency (CEE) which includes physical and financial capital efficiency. HCE and SCE constitute intellectual capital efficiency (ICE) (Fijałkowska, 2014).

Litigation risk and financial reporting quality

Litigation occurs because accounting practices carried out by the company are not performed by the existing legal and regulatory provisions. It also arises as a result of hidden negative information with a potential legal risk embedded to mislead the consumers. Management cover or hide such information from interested parties it also strives to produce reports that make these parties continues to believe and be interested in the company (Jackson, et al, 2015). The management revised reports to make it appear useful to the stakeholders for the continuous injection of funds into the company. However, this worsens the report worse because the information displayed does not show the actual situation; rather it appears to be manipulated. Reports need to be in perfect condition, which is the basis of decision making, for the company to continue acquiring capitals

for its operations. When the information reported appears to be too real, the management becomes concerned that the parties might not be interested in the company and does not inject funds, which leads to failure in the operation of the establishment. Management as a company agent certainly does not want this to happen, especially when the compensation given is assessed based on the results of its performance. It strives for the company to continue operation and generate profits that serve as returns for the principal. Laux and Stocken (2011) also stated that the greater the expected legal penalties faced by companies, the more the management tends to be aware of their reports. Jackson, et al. (2015) and Boone, et al. (2011) established that it significantly influences financial reporting quality and help companies' objectives to be achieved by supervising the activities that caused the low-quality financial reporting.

THEORETICAL FRAMEWORK

Human capital theory

Human capital theory was propounded by Schultz in 1961 and further developed by Becker in 1964. The theory recognized the importance of investment on the individual employees as it established relationship between the education, training and development of the employees and their productivity. The education, training and development obtained by the employees will benefit both the employees and the organization as the performance of the organization is a reflection of the performance of the employees. This theory can be traced to the macroeconomic development theory. The theory proposes that the investment on the individual employee in terms of education, training and development will have resulted in gaining more knowledge and skills for the employees. The knowledge and skills gained by the employees during the education, training and development programs will help the employees to perform their job better as the performance of the employees will be increased. That is, the increment in the employees' performance will then result in the improvement in the performance of the organization. It also indicated that the knowledge and skills gained by the employees would increase the future income of the employees as a result of the increment in their lifetime earnings. The theory also recognized that the individual employees who do not improve their knowledge and skills through education, training and development will have less skills and knowledge than the educated ones and therefore be less productive.

Empirical framework

Akpan, and Otung (2020) investigated the effect of intellectual capital on economic value added of listed banks in Nigeria. The data for the data were secondary derived from the annual reports of these banks and Nigeria Stock Exchange fact books. The research design adopted was e*xpo facto* research and the study covered a period of four years from 2015 to 2018. The sample size of 12 banks were selected using Cochran model. Intellectual capital is measured using Value Added Intellectual Coeffiecient (VAIC) developed by Pulic. Data were analyzed using descriptive statistics and ordinary least square regression technique. The results obtained show that human

capital efficiency, structural capital efficiency and capital employed efficiency significantly influence economic value added of listed banks in Nigeria. The study therefore concluded that IC efficiency is positively associated with economic value added of banks in Nigeria. Thus, this study recommended that the apex bank and other regulatory agencies should strengthen the enforcement of policies and measures that would promote intellectual capital development, as this would in turn enhance economic value added of these banks.

Fotourehchi, et al, (2019) investigated whether information transparency and the efficiency of intellectual capital affect the cost of shareholders' equity of listed companies in Tehran Stock Exchange. In this study, a systematic deletion method has been used to determine the statistical sample. Also, in order to investigate the effect of information transparency and intellectual capital efficiency on equity costs, a multivariate regression model with panel data and a randomized model estimation method have been used. To measure the efficiency of intellectual capital, the researchers used the value-added coefficient of intellectual capital proposed by PALIC. Also, Gordon's model has been selected to calculate the cost of equity. The results of model estimation show that there is no relationship between information transparency variable (P = 0.3333) and structural capital efficiency (P = 0.430) with cost of owners' equity, and also the relationship between the efficiency of intellectual capital(P = 0.0181), Human capital(P = 0.0077) and physical capital(P = 0.0053) at the cost of equity at a 99% confidence level.

Ogbonnaya and Basil (2019) assessed the impact of intellectual capital on financial reporting quality of selected banks in Nigeria. The specific objective of the study was to investigate the impact of Intellectual capital on financial reporting quality on selected Banks. A total of ten banks were selected for the study from 2006-2017. Regression analysis was used to do the analysis. They study made use of Value Added Intellectual Coefficient (VAIC) to ascertain the extent of intellectual capital indices while financial reporting quality is proxy by accrual which was calculated using Dechow and Dichev's (2002) model. The result indicated a positive impact on financial reporting quality. The study therefore concludes that Banks should pay more attention to the three intellectual capital variables to improve their financial reporting quality. The study recommends that the three variables of intellectual capital should be well handled in other to have higher quality of financial reporting quality and also provide enabling environment needed to achieve a vital human capital in their system.

Habib, et al. (2014) researched Litigation risk, financial reporting and auditing: A survey of the literature. This paper surveys the literature on the determinants and consequences of securities class action lawsuits against firms and auditors from a financial reporting quality perspective. The survey is motivated by the important role that law plays in protecting stakeholders' interests against managerial misdeed. Litigation is, thus, an important topic and numerous studies investigate the determinants and consequences of firm and auditor lawsuits. The underlying premise of these studies is built on the notion that large financial and reputational penalties

associated with successful securities class actions can discipline management and deter them from future wrongdoing. The survey documents that poor quality financial reporting as evidenced in earnings restatements has been the primary antecedent for class action lawsuits against the firm and auditors. Lawsuits against auditors affect audit fees, audit planning decisions and client portfolio adjustment decisions. Although significant progress has been made in terms of further understanding the causes and consequences of litigation against auditors, major challenges remain in the area of proper measurement of litigation risk.

METHODOLOGY

The research design employed in this study is the *ex-post facto* research design. The population of the study consists of all listed manufacturing companies in the Nigeria exchange group plc (NGX) as at 31st December, 2021. Purposive sampling technique was adopted to select the firms with up to date and complete annual reports and accounts for the study period (2017-2021). The sample size of this study consist of fourteen (14) listed firms that were continuously listed and actively trading on the floor of the Nigerian Exchange Group plc (NGX) during the period 1st January 2017 to 31 December 2021 and whose financial statements are available and have been consistently submitted to NSE for the period under study. The study made use of secondary data. The data were sourced from publications of the Nigerian Exchange Group Plc (NGX), fact books and the annual report and accounts of the sampled companies, particularly the comprehensive income statement and statement of financial positions of these firms as well as their respective notes to the accounts. Data was analyzed using the regression analysis, using intellectual capital as the independent variable, with the dependent variable as the financial reporting quality. The proxy for intellectual capital is human capital efficiency. Litigation risk was taken as the control. The Financial reporting quality was measured using real earning management. Litigation risk in this study was conducted through the analysis of solvency and court cases.

Method of data analysis

Descriptive statistics was used to summarize the mean, median, standard deviation, skewedness, kurtosis, maximum and minimum of the study variables. Inferential statistics of the stated hypotheses will be carried out with the aid of E-view 9.0 statistical software, using:

Pearson coefficient of correlation which is a good measure of relationship between two variables, tells us about the strength of relationship and the direction of relationship as well. Due to the panel nature of the data, fixed effect and random effect regressions were run. Ordinary Least Square (OLS) Regression Analysis was used for the study.

Model specification

The study adopted the Pirjo, Sten and Samuli (2011) VAIC model. The variable is synthesized by factor analysis in order to determine the litigation risk index. A high index value indicates an enormous litigation risk and vice versa.

The Basu (1997) model of measuring earnings quality as proxy for financial reporting quality using accruals was adopted for the study. Financial reporting quality is determined by using accruals. Non-operating accruals (NoACC) can be calculated by the following relations:

ACC= NI+ DEP- CFO
NI: Net profit before Items
DEP: Depreciation Expense Payable
CFO: Cash Flow from Operations
The model designed for the study is given as:
VAIC = α +β1FRQit+ ε
With VAIC = value added intellectual capital
FRQ - financial reporting quality
In order to ascertain the impact of Human capital efficiency HCE on litigation risk**,** the following econometric models were specified:
Y = *f*(X) +μ . The above model could be re-constructed as thus;
$HCE_{it} = \beta 0 + \beta 1 LRISKit + \mu it$ …… (1)
Where: β0 = Intercept of the regression β1 = Coefficients of Litigation Risk μít = error term capturing other explanatory variables not explicitly included in the model of firm í in period t Y = dependent variable (HCE) t = time period (1, 2 ..... 5)

PRESENTATION OF FINDINGS

Table 1: Descriptive Statistics
OBS=14

	Minimum	Maximum	Mean	Std. Deviation	Skewness		Kurtosis	
	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
HCE	1.09	47.07	6.5651	8.90265	2.976	.287	9.075	.566
VAIC	.92	40.62	5.8433	7.27607	3.104	.287	10.733	.566
FRISK	.13	.93	.4941	.19362	.291	.287	-.463	.566
LITIGA	1.00	2.00	1.4429	.50031	.235	.287	-2.003	.566
FRQ	-.55	1.14	-.0094	.20790	2.477	.287	14.143	.566
Valid N (listwise)								

Source: Researcher computation 2022

Table 1 presents the summary of mean and standard deviation of the dependent and independent variables. The mean of Human capital efficiency (HCE) is about 66% with standard deviation of 8.9, indicating very high dispersion from the mean. This implies that the companies differ significantly with respect to their human capital efficiency.

The litigation risk has a mean value of 1.44 with standard deviation value of .500. The low standard deviation value indicates that the scores cluster around the mean. Financial reporting quality (FRQ) has a maximum and minimum mean values of 1.14 and -.55 respectively and a mean value of -0.0094. The standard deviation value is .207, quite larger than the mean value, indicating that the values are dispersed and that the companies differ in their financial reporting quality.

Table 2: Correlation matrix

		HCE	VAIC	FRISK	LITIGA	FRQ
HCE	Pearson Correlation	1				
	Sig. (2-tailed)					
VAIC	Pearson Correlation	.706**	1			
	Sig. (2-tailed)	.000				
FRISK	Pearson Correlation	-.039	-.194	1		
	Sig. (2-tailed)	.749	.108			
LITIGA	Pearson Correlation	-.035	.081	-.003	1	
	Sig. (2-tailed)	.775	.505	.982		
FRQ	Pearson Correlation	.284*	.080	-.287*	-.061	1
	Sig. (2-tailed)	.017	.511	.016	.618	

Source: Researcher computation 2022

Table 2 presents the correlation between and among the variables. The result shows that human capital efficiency (HCE) has a negative relationship with litigation risk (-.035) and a positive relationship with financial reporting quality (.284).

Testing of hypotheses

H_{01}: There is no significant relationship between Human Capital Efficiency (HCE) and qualift if financial reporting of listed manufacturing firms in the Nigerian Exchange group.

Table 3: Summary of panel data regression analysis for relationship between human capital efficiency and litigation risk

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.017156	0.034428	0.498312	0.6187
HCC	0.005964	0.001223	4.875479	0.0000
FRQ--LITIGATION_RISK	-0.019101	0.024986	-0.764467	0.4452
HCC--LITIGATION_RISK	-0.019101	0.024986	-0.764467	0.4452
LITIGATION--LITIGATION_RISK	-0.019101	0.024986	-0.764467	0.4452
RISK--LITIGATION_RISK	-0.019101	0.024986	-0.764467	0.4452

R-squared	0.083208	Mean dependent var	0.028753
Adjusted R-squared	0.066478	S.D. dependent var	0.187149
S.E. of regression	0.180821	Akaike info criterion	-0.561420
Sum squared resid	8.958796	Schwarz criterion	-0.483531
Log likelihood	84.59874	Hannan-Quinn criter.	-0.530178
F-statistic	4.973653	Durbin-Watson stat	1.677264
Prob(F-statistic)	0.000224		

Source: Researcher computation 2022

Table 3 summarizes the pooled ordinary least square (OLS) regression test. The result shows that human capital efficiency HCE rises, quality of financial report also rises. This shows a linear positive effect of HCE on financial reporting quality. The result also shows that the probability value is .000, indicating that the result is significant. Thus, that there is a significant relationship between Human Capital Efficiency (HCE) and litigation risk of listed manufacturing firms in the Nigerian Exchange group.

H_{02}: There is no significant moderating effect of litigation risk on the relationship between Human Capital Efficiency (SCE) and the quality of financial reports of listed manufacturing firms in the Nigerian Exchange group (NGX.

The result in Table 3 further shows that when moderated with litigation risk, there is an inverse relationship with financial reporting quality (FRQ) with a coefficient value of -.019101. The Fstat is 4.9736 and the probability of F is .0002. Hence, the result is statistically significant. Thus, there is a significant relationship between human capital efficiency (HCE) and quality of financial reports of listed manufacturing firms in the Nigerian Exchange group (NGX) using litigation risk as a moderating variable.

DISCUSSION OF FINDINGS

Result of analysis indicates that human capital efficiency (HCE) (HCE) has a negative relationship with litigation risk (-.035and a positive relationship with financial reporting quality (.284). The

hypothesis test confirms that there is a significant relationship between human capital efficiency (HCE) and quality of financial reports of listed manufacturing firms in the Nigerian Exchange group (NGX) using litigation risk as control. Human capital efficiency in this perspective is still viewed as a liability and expense compared to the tangible benefits of other costs. This finding is in line with Fotourehchi, Ebrahimpour and Panahi (2019) whose results show that the efficiency of intellectual capital, human capital and physical capital is related to the cost of equity, but there is no relationship between the variables of risk and the efficiency of structural capital with the cost of equity. This finding is also in supported by Ogbonnaya & Basil (2019) whose result indicated a positive impact on financial reporting quality. This finding is also in line with Habib, et al. (2014), who found that poor quality financial reporting as evidenced in earnings restatements has been the primary antecedent for class action lawsuits against the firm and auditors.

CONCLUSION

Based on the findings of the study, it is concluded that human capital efficiency has a negative relationship with litigation risk. As intellectual capital rises, litigation risk of companies decreases.

Recommendations

Based on the results of the empirical analysis, the following set of recommendations are made:

i. Companies are encouraged to explore how human capital and company reputation activities could positively be managed jointly, since organizations may manage these concepts in separate business areas.

ii. Additionally, the findings of the study suggest that the areas of corporate reputation, risks and human capital accounting are strongly interrelated, so it follows that these concepts could be managed in an integrated way by company executives.

iii. Establishing and maintaining proper relationship with other entities still boils down to managing human capital. This entails creating relational awareness in the employees through adequate training in the aspect of customer relation and proper management of financial and material resources available for firm use.

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