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A review of intellectual capital disclosure from the sell-side analyst perspective

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A review of intellectual capital disclosure from the sell-side analyst perspective, from extant literature

Abstract

Using extant literature, this paper examines a number of key issues relating to sell-side analysts disclosing intellectual capital (IC), addressing some of the weaknesses and gaps. The paper begins by reviewing the IC and analyst literature from the perspective of sell-side analyst research. It then reviews theoretical perspectives with a view to providing diverse analogies from both positivist and critical angles. Methodological issues are scrutinized to review limitations and to strengthen the application of research methods. The paper concludes by arguing for broadening the research base of sell-side analyst research and offers suggestions for doing so.

Keywords: analyst, intellectual capital, intellectual capital disclosure, sell-side analyst
A review of intellectual capital disclosure from the sell-side analyst perspective

1. Introduction

Changes in the business environment from the industrial era to the new economy has transformed the corporate value creation process and strategy, particularly for firms in non-traditional industries (Lev & Zarowin, 1999). The potential for creating competitive advantage and long-term corporate value, now lies more importantly in effective management of intangibles or intellectual capital (IC) than in tangible assets (Daley, 2001; García-Ayuso, 2003; Guthrie, Petty & Johanson, 2001; Petty & Guthrie, 2000). Commensurate with the changes in the corporate value creation process, traditional financial reporting systems become inadequate in providing decision-useful information to stakeholders due to their limitedness in the identification and measurement of IC in organizations (Ashton, 2005; Bornemann & Leitner, 2002; Stewart, 1997).

Guthrie et al. (2001) identified three evolving intellectual capital (IC) missions: (1) ‘developing systems for creating, capturing and disseminating IC within organisations’ for internal strategic decision-making; (2) ‘establishing new measures, (3) and ways of reporting externally the value attributable to IC’. These missions encompass the information needs of the managers for the internal management of the firm and the information needs of investors for valuing the firm as an investment opportunity.

The proportional increase in the corporate value derived from IC has resulted in capital market intermediaries such as sell-side analysts and fund managers requesting more information on firms’ IC (Eccles & Mavrinac, 1995; Holland, 2003; Holland & Johanson, 2003; Mavrinac & Siesfeld, 1998).
There are two streams of IC disclosure-related literature that can be clearly identified. One focuses on the extent and nature of IC disclosed by firms and the other pertains to the use of IC information by financial analysts as presented in their reports. Financial analysts in the capital market comprise sell-side analysts and buy-side analysts. Sell-side analysts work for brokerage firms and produce public reports influencing the supply side of information. The institutional investors employ the buy-side analysts to make recommendations, exclusively, on the asset portfolio of that institutional investor.

This paper debates on IC disclosure by sell-side analysts, using extant literature. The next section debates the broad literature from the perspective of sell-side analysts attempting to disclose IC in their reports. Section 3 reviews a number of theories that can enrich research on IC disclosure by supply-side analysts. Section 4 examines different research methods, recent trends, and ways to strengthen future research. Section 5 offers concluding remarks about the debate on IC disclosure research by sell-side analysts.

2. A debate on literature

Barth, Kasznik and McNichols (2001) contend that there is information asymmetry between firms and investors, especially in firms with substantial intangibles assets. Regardless of the movement towards greater disclosure of non-financial performance measures and IC in particular by firms (Abeysekera & Guthrie, 2005; Guthrie & Petty, 2000; Sujan & Abeysekera, 2007 (forthcoming)), evidence suggest that firms disclose much less than what analysts expect (Carnaghan, 1999; García-Ayuso, 2003). A number of studies have been conducted on the IC usage and disclosure by sell-side analysts by content-analysing their reports presented to the investing community (Arvidsson, 2003; Breton & Taffler, 2001;
Schipper (1991), contends that sell-side analysts are among the primary users of accounting information and represent an important group in financial reporting. The sell-side analyst reports are a primary source of information for buy-side analysts (2005; Holland, 2006; Holland & Johanson, 2003). Individual investors obtain such information either directly or through sell-side analyst reports to make security evaluation decisions (Marcus & Wallace, 1991). The important role thus played by sell-side analysts in the demand side of the market for corporate information has underpinned the vast body of literature on analysts’ decision processes, with the sell-side analysts’ valuation of firms as a market proxy (Schipper, 1991).

In this context, a number of studies have been conducted on the usage of non-financial information (Breton & Taffler, 2001; Fogarty & Rogers, 2005; Previts et al., 1994; Rogers & Grant, 1997) and IC information (Arvidsson, 2003; Flöstrand, 2006; García-Meca, 2005; García-Meca & Martínez, 2005; Nielsen, 2004) in sell-side analyst reports.

An enormous amount of work has been carried out in devising models and frameworks for identifying, classifying, measuring, managing and reporting IC within firms. Models such as the Balanced Scorecard (Kaplan & Norton, 1992; Kaplan & Norton, 1996), Skandia Business Navigator (Edvinsson & Malone, 1997), Invisible Balance Sheet (Sveiby, 2005; Sveiby, 1989; Sveiby, 1997), and Technology Broker (Brooking, 1996) are the results of the work of proponents in this domain to assist information suppliers such as sell-side analysts, although utility of some of these tools has mainly been used for internal strategic decision-making.\[1\]

A vital information source for sell-side analysts about firms is their public documents (Arnold & Moizer, 1984; Fogarty & Rogers, 2005). In the context of IC, external disclosure
of IC has been on the agenda since the late 1980s (Petty & Guthrie, 2000) as evidenced by the early works of Sveiby(1989). This initiative was more formally recognized by the accounting profession by the appointment of the Jenkins Committee of the American Institute of Certified Public Accountants (AICPA, 1994; Ashton, 2005; Wallman, 1995) to address the challenge of voluntary disclosure of IC information in public documents such as annual reports. Certain firms, particularly in Europe, produce a separate IC statement to supplement their conventional annual report information deficit. Commensurate with these developments last decade has seen an enormous interest by researchers and firms, in many parts of the world, in supplying IC information in public documents.

The contributions to the IC disclosure literature in Australia (Guthrie, 2001; Guthrie & Petty, 2000; Guthrie, Petty, Ferrier & Wells, 1999), Canada (Bontis, 2003; Carnaghan, 1999), Denmark (Arvidsson, 2003; Bukh, Nielsen, Gormsen & Mouritsen, 2005), Finland (Arvidsson, 2003), France (Vergauwen & van Alem, 2005), Germany (Vergauwen & van Alem, 2005), Hong Kong (Petty & Cuganesan, 2005), Italy (Bergamini & Zambon, 2002; Bozzolan, Favotto & Ricceri, 2003), Ireland (Brennan, 2001), Japan (Nielsen et al., 2005), Malaysia (Goh & Lim, 2004), Netherlands (Vandemaele, Vergauwen & Smits, 2005; Vergauwen & van Alem, 2005), Norway (Arvidsson, 2003), Portugal (Oliveira, Rodrigues & Craig, 2006) Singapore (Firer & Williams, 2005), South Africa (April, Bosma & Deglon, 2003), Spain (García-Meca & Martínez, 2005; Oliveras & Kasperskaya, 2005), Sri Lanka (Abeysekera & Guthrie, 2005), Sweden (Arvidsson, 2003; Vandemaele et al., 2005), UK (Citron, Holden, Selim & Oehlcke, 2005; Vandemaele et al., 2005; Williams, 2001), and the USA (Abdolmohammadi, 2005) are notable in examining the supply-side of IC in public documents.

The literature categorizes IC information units (items) into external capital, human capital and internal capital categories. Among them, Abeysekera and Guthrie (2005) provide a more comprehensive list of IC items; with the external capital category comprising 10 IC items, the
human capital category comprising 25 IC items, and the internal capital category comprising 10 IC items.

The external capital category is clustered into five sub-categories. These are brand-building, corporate image-building, business partnering, distribution channels and market share. The brand-building sub-category includes intellectual capital items such as brands, customer satisfaction, and quality standards. The corporate image-building sub-category includes intellectual capital items such as firm name and favourable contracts. The business partnering sub-category includes business collaboration, licensing agreements, and franchising agreements. The stand-alone sub-categories are distribution channels, and market share (Abeysekera & Guthrie, 2005).

The intellectual capital items in the human capital category are clustered into seven sub-categories. They are training and development, equity issues, employee relations, employee welfare, employee-related measurements, entrepreneurial skills, and employee safety. The training and development sub-category comprises know-how, education, vocational qualifications, career development, and training programs. The equity issues sub-category comprises equity issues relating to race, gender, religion and disability issues. The employee relations sub-category comprises union activity, employees being thanked, employees featured in the source documents and employee involvement with the community. The employee welfare sub-category comprises employee compensation plans, executive compensation plans, employee benefits, employee share plans, and option ownership plans. The employee-related measurements sub-category comprises value-added per employee in value-added statements, value-added per expert in value-added statements, employee numbers, professional experience, education levels, expert seniority, and age of employees.
The stand-alone sub-categories are entrepreneurial skills, and employee safety (Abeysekera & Guthrie, 2005).

The intellectual capital items in the internal capital category are clustered into four sub-categories: these are processes, systems, intellectual property, philosophy, culture, and financial relations. The processes sub-category includes both management and technological processes. The systems sub-category includes both information systems and networking systems. The intellectual property sub-category includes patents, copyrights and trademarks. The stand-alone sub-categories are philosophy, culture and financial relations (Abeysekera & Guthrie, 2005).

The difficulty of measuring IC items recognized in financial statements has restricted the ability to investigate the process and disclosure of IC on value creation in an experimental fashion. The abundant literature on sell-side analysts and researchers examining financial items recognized in the financial statements to determine their impact on aspects of value creation is a testimony to this effect. These financial items include accruals (Livant & Santicchia, 2006), cash flows (Govindarajan, 1980; Sloan, 1996), and their impact on future returns.

Some IC items are specific to firms and others are less specific to firms. This has exacerbated the challenge of making statistically valid inferences about the relationship between various IC items and value creation of firms. IC and intangible assets are difficult resources to translate to predict stock prices because it is difficult to interpret how various elements of IC are linked in the value creation chain (Holland, 2003) and the value of IC is entangled with other assets (Mouritsen, 2003). For instance, IC items in internal capital category are specific
to firms, but some external capital items (e.g., customer satisfaction) and some human capital items (e.g., relations with unions, involvement with the community) are less specific to firm.

The firm-specific IC items contribute heavily to the beta risk factor[2], with the variation in value creation being benchmarked by the firm and industry forces, whereas less firm-specific IC items contribute lightly to the beta risk factor, with the firm having less control over value creation. Since the importance of IC items can change over time for value creation in a firm, these changes contribute to changing the firm-specific risks over time. There are quantifiable factors contributing to the beta risk factor (e.g., level of market capitalisation of shares of the firm, riskiness of the industry sector, errors in measuring industry sector changes), to determine variations in aspects of value creation (Bennett & Sias, 2006). However, the difficulty of quantifying IC items for value creation restricts statistical analysis longitudinally of changes in the value creation process, posing a challenge to sell-side analysts in disseminating an accurate valuation of IC information.

The risk analysis, and hence the portfolio allocation information provided by sell-side analysts, become crucial in informing shareholders and stakeholders about various aspects of value creation. The role of sell-side analysts is more than calculating financial ratios (Fridson, 1997), and neglect of evaluating non-financial information such as IC can lead to neglect of informing about signs of trouble and good times.

3. Theoretical perspectives

Assuming the basic premise that sell-side analysts meet the information needs of other stakeholders (i.e., buy-side analysts and retail investors), sell-side analysts play the role of information dissemination towards market efficiency by reducing information asymmetry.
This is pertinent to disseminating IC information with the exponential growth of knowledge-based firms (Romer, 1998) and the growing demand for knowledge-based products and services in the global economy (King & Ranft, 2001). The signalling of disclosure by sell-side analysts is one way of responding to perceived market failure when the market does not have full information (Erdem & Swait, 1997; Spence, 2001; Watts & Zimmerman, 1986, pp. 163–166) and demonstrates that buy-side analysts trade upon share recommendations of sell-side analysts and achieve superior performance (Chen & Cheng, 2006; Li, 2005). The signals are often country-specific (Hall, Hutchinson & Michaelas, 2004).

As a sell-side analyst is an intermediary, the source of signalling originates within the firm. Depending on whether disclosure signals meet certain conditions, stakeholders will believe some signals to be true and reject others. These conditions include that management has sufficient incentive to disclose, that the signal is difficult to imitate, that there is an observable relationship between the firm disclosure and stakeholder perception, and that the signals are cost-effective. Management is believed to have sufficient incentive to disclose when the firm is dependent on stakeholders to continue as a going concern (Toms, 2002). These signals of IC disclosure to sell-side analysts should provide a competitive advantage to the firm, as the firm would be disclosing items that are difficult to imitate by others.

In contrary to the sell-side analyst helping in market efficiency, some studies have highlighted information bias due to power-plays with other actors (Zhang, 2006), and their dependency on actors for revenue (Carpenter, 2005). The literature supports the view that retail investors and buy-side analysts have different expectations from sell-side analysts and vice versa (Walker, 2006; Wayman, 2002). In such expectations, retail investors are unaware of the level of bias of sell-side analysts in information dissemination in the form of
buy/sell/hold recommendations. The retail investors appear to accept these recommendations on their face value, but buy-side analysts review the trends of such recommendations before making decisions (Boni & Womack, 2003). The regulations set by the USA Attorney General in 2003, the Australian Securities and Investments Commission (ASIC), and Société Française des Analystes Financiers (SFAS) in 2002 highlight the repeated calls for truthful forecasts by sell-side analysts (Galanti, 2006). The past research has largely neglected the role of power-play and victimization from information disseminated by sell-side analysts.

The analysis of sell-side analysts’ IC information source, the type, nature and extend of IC disclosure in their reports, and how such information is linked with recommendations, earnings forecasts or price targets, from the aspect of power is a worthwhile research proposition. This is more so with the empirical evidence that investors consider IC as an economic asset, and reporting such information shows a strong association with subsequent share returns, with a simultaneous augmentation between the market value and book value of firms (Amir, Lev & Sougiannis, 2003; Ballester, Garcia-Ayuso & Livnat, 2003).

The influence of power over sell-side analysts may originate from the firm, buy-side analysts, and indirectly through investment banks (Burgman & Roos, 1997; Wayman, 2002) for which the sell-side analysts recommend shares, or at a larger scale due to a wider institutional framework in which the sell-side analyst operates. The recommendations made by sell-side analysts are about capital; to retain, move out, or move in.

Capital is more than a mere collection of transferable resources. From a critical perspective, capital is an institutional system through which firms differentiate technology and organisational structures are progressively developed (Clegg & Dunkerley, 1980, p. 5).
The nature of capital accumulation in the economic environment has changed due to chaotic searching for profits, new products and markets, new technologies, new spaces and locations, and new processes of firms. It is imprudent to analyse capital as if it were immobile and attached to particular activities and firms, with the increasing mobility of capital (Holloway, 1994). The transience of capital makes it imperative for a firm to convince shareholders to remain with the most value-creating firm, an activity on which firms can collaborate with the sell-side analysts through their recommendations.

From the viewpoint of political economy, this productive exchange system of information between sell-side analysts and others is about the interplay of power and the goals of power-wielders. Political economy as a framework extends analysis from market exchanges to the relationships between power-wielders (Jackson, 1982, p. 74). Political economy analysis has the following three characteristics: first, it destroys the observed illusionary reality of social processes and structures; second, it elucidates the various ways of dominating, defining, mediating, and legitimating activities; third, it goes beyond economic efficiency and inquires about moral questions of justice, equity and public interest (Boczko, 2000, pp. 131–153).

The focus of political economy analysis is upon the way an entity (e.g., firm, brokerage houses) allocates resources and makes decisions from a broader perspective. In this broader perspective, the political economy view of the constitution of an entity has three dimensions: first, entity is located in the society that is goal-directed and deliberately structured (Samson & Daft, 2003, p. 14); second, it is a set of agreements and understandings which define the limits and goals; and third, the entity creates rights and responsibilities for those who participate (constituents) in relation to the entity (Jackson, 1982, p. 74).
Political economy in accounting takes place where accounting becomes a way for firms to sustain and legitimize their activities to social, economic, and political constituents (Cooper, 1980, p. 164). Within this construct, disclosure in accounting reports such as annual reports is viewed as a means to create, sustain, and legitimize activities in the private interests of the entity (Abeysekera, 2006; Guthrie & Parker, 1990) and is suggested as a more suitable and germane way of analysing sell-side analysts’ practices. Further, the political economy of accounting view is that activities of firms for capital accumulation can create tension between entities and their constituents (Buhr, 1998) and these entities proactively provide disclosure within their accounting reports, from their perspective, to set and shape their agenda to mediate, suppress, mystify or transform such tension (Guthrie & Parker, 1990). This tension may be analyzed by market forces (capital or economic); bureaucratic controls (state or political); and spontaneous solidarity (community or social). The tensions and how sell-side analysts set and shape their agenda to reduce this tension can be better understood by comparing and contrasting them to the sources of motivation that lead to the disclosure of IC information in their reports (Puxty, Willmott, Cooper & Lowe, 1987).

The globalization has transcended the interaction between retail investors, institutional investors, buy-side analysts, and sell-side analysts beyond national boundaries. Although there are competing arguments and propositions about the good and bad effects of globalization on developing economies (Cox, 1996; Fligstein, 2001; Pierson, 1998; Rodrick, 1997), the reality is that it has changed the composition of constituents involved in determining the value creation of firms, namely political, economic and social – from national level to international level. The breaking down of geographic barriers, decreasing transaction costs, and more freely available capital in the intangible economy are affecting the entire world. These phenomena have made IC more valuable, thus allowing knowledge-
based firms to earn even higher profits (Daley, 2001). The change in the dynamics of constituents can contribute to the variations in industry-specific risks and market risks. Hence, the examination of sell-side analyst practices and their information in the context of developing economies requires a framework that recognises the effects of globalization (Cheng, Bennett & Zheng, 2006).

Capital concentration and dispersion between countries is a fruitful perspective to explore the utilisation and disclosure of IC information by sell-side analysts. As the peripheral capitalism perspective argues, the articulation of mechanisms such as globalization and capital markets in the underdeveloped economies within the world economic system results in the transfer of resources from developing countries (peripheries) to the centres of global capital in the developed countries. The largely unidirectional transfer of capital through various mechanisms that block the equitable flow of capital can enable the centres to distort the allocation of resources in the periphery (Amin, 1976, pp. 143–154; Henry, 1985, pp. 99–140). The peripheral capitalism perspective helps to understand the role of sell-side analysts in IC disclosure practices in the larger context of capital migration across the globe.

4. Methodological perspectives

Sell-side analysts studies have largely resorted to statistical analytical techniques. This is because such studies have been driven by investigating variables recognized in financial statements (Livant & Santicchia, 2006) using data available from external databases (Bennett & Sias, 2006; Chen et al., 2006). A recent trend has emerged, of scholars applying qualitative techniques to understand the broader dynamics of sell-side analysts (Bukh, 2007; Johansson, 2007).
A number of recent studies have been conducted on the usage of IC information by sell-side analysts by content-analysing their reports presented to the investing community (Arvidsson, 2003; Flöstrand, 2006; García-Meca, 2005; García-Meca & Martínez, 2005; Nielsen, 2004).

While many authors have been quick to commend content analysis for producing an objective, systematic and reliable analysis of data (Guthrie & Petty, 2000), few have addressed the methodological problems associated with content analysis that can distort the findings of such analysis or, indeed, the credibility of its original textual source (Abeysekera, 2006).

One major limitation associated with the content analysis method is the subjectivity involved in the coding process (Deegan & Rankin, 1996; Frost & Wilmshurst, 2000). For instance, the method is heavily reliant on the integrity of the coder or researcher. Several other limitations are controllable by the researcher by careful planning of research. First, sell-side analysts’ studies often tend to overlook the fact that results may differ depending on the scale applied for counting. The common scales applied for counting include the nominal, ordinal, interval and ratio scales. The purpose of the ordinal scale is to ascertain IC disclosure trends through frequency. The nominal scale establishes the median and interval of IC disclosure. The ratio and interval scales seek to quantify the distance between IC disclosure items (Carney, 1972, pp. 153–154).

There are issues relating to the operationalizing of content analysis. These include how to deal with sentences or paragraphs that give rise to more than one intellectual capital item or ‘attribute’. One or more IC attribute(s) can give rise to an IC category such as human capital, internal capital, and external capital. Additionally, there are issues related to how one would
convert non-narrative information such as pictures, charts, tables, and numerical figures (both fiscal and non-fiscal) into a quantitative form to be analysed by content analysis. Operational definitions therefore can give rise to differences in both results and interpretation.

Another method used, although to a limited extent, in sell-side analysts’ studies in the context of IC disclosure (Bukh, 2007) is case-study interviews. However, McKinnon (1988, pp. 36–52) points out that the validity and reliability of case-study interviews can be compromised by five factors, all of which were applicable to this study. These factors are: observer-caused effects; interviewer-bias effects; data access limitations; complexities and limitations of the human mind; and low objectivity.

First, the respondents can change their behaviour in interviews, giving rise to observer-caused effects. The respondents may not be factual in their answers as they also have ‘their own agendas’ in answering the interview questions (Goddard & Powell, 1994). Second, interviewer-bias effects can affect the registering, interpreting and coding of the interview. Third, the interview can result in limited quality and quantity of data by the fact that data-gathering through the interview method is restricted to the period of that interview. Fourth, the researcher cannot take statements made by respondents at their face value, because of the complexities and limitations of the human mind. This is because sell-side analysts as respondents can consciously seek to mislead or deceive the researcher about information related to them. Even if respondents attempt to reply to the questions as honestly and accurately as possible, their statements can still be affected by natural human tendencies and weaknesses. Fifth, the interview method relies heavily on the experience, and intellectual honesty of the researcher due to the very nature of the method (McKinnon, 1988, pp. 36–52).
The above-mentioned factors can influence the quality of IC-based sell-side analysts’ research results and interpretation.

5. Concluding remarks

The disclosure of IC by sell-side analysts is a product of complex interactions. At a micro level, the firm, buy-side analysts, and investment bankers have an influence on their disclosure. At a macro level, the stock exchange and government as regulators and policy-makers can influence the nature and the coverage of disclosure (Burgman & Roos, 2007). At a global level, the extent of openness to the forces of globalization, the buy-side analysts and retail investors can influence the IC disclosure to meet their expectations. Hence, it appears that IC disclosure by sell-side analyst is a product of reactive interaction. Research highlights the incompleteness of sell-side analysts’ reports, especially for non-financial information (Abdolmohammadi, Simmett, Thibodeau & Wright, 2006), and over-optimism (Bradshaw, Richardson & Sloan, 2006; Gillies, 2006). However, sell-side analysts appear to frequently use IC indicators in their reports with variations across industry sectors, with the majority of them referring to external capital (Flöstrand, 2006). With research supporting the view that buy-side analysts listen to sell-side analysts’ recommendations for superior performance (Chen & Cheng, 2006; Li, 2005), the examination should revolve around the neutrality of IC indices prepared by sell-side analysts.

The theoretical underpinning of sell-side analysts’ research on IC disclosure studies is in its infancy and it is an opportune time to bring in theoretical rigor to future studies. While positivist theories can certainly contribute to this process, it is argued that critical perspectives can enrich and diversify the research base. The recent welcome trend in sell-side
research using qualitative research methods would benefit with more rigor in methodologies.

This paper is just the beginning of the debate about sell-side analysts’ IC disclosure research.
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[2] Two risk factors, the alpha factor and beta factor, determine the relative return. The alpha factor is the relative return generated in excess of benchmark return set by the management in the firm (Kozhemiakin, 2006).