

Financial Reporting of Relational Capital: Enhancing Transparency and Competitive Advantage in SMEs

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Abstract

This paper examines the role of financial reporting of relational capital in enhancing transparency and competitive advantage in small and medium-sized enterprises (SMEs). Relational capital—the value embedded in relationships with customers, suppliers, partners, and other stakeholders—is a critical intangible asset for SMEs but remains poorly captured in traditional financial statements. Using a mixed-methods approach that combines a systematic literature review, conceptual framework development, and an empirical study based on survey and archival data from manufacturing and service SMEs, this study develops measurement propositions and testing strategies for reporting relational capital. Results indicate that improved disclosure of relational capital correlates with greater perceived transparency, higher investor and creditor confidence, and measurable improvements in competitive indicators (market share growth, customer retention, and margins). The paper proposes an integrated reporting model and practical guidance for SMEs and standard-setters, discusses implications for accounting practice and policy, and identifies avenues for future research. Keywords: relational capital; financial reporting; SMEs; transparency; competitive advantage; intangible assets.

Introduction

Small and medium-sized enterprises (SMEs) constitute the backbone of many economies worldwide, contributing significantly to employment, innovation, and economic growth (OECD, 2019). In competitive markets, intangible assets increasingly determine firm value—particularly relational capital, the set of firm-specific relationships and networks that facilitate access to resources, markets, and capabilities (Nahapiet & Ghoshal, 1998). Unlike physical assets, relational capital is difficult to quantify and is often omitted or underreported in financial statements, creating a transparency gap that can constrain SMEs' access to finance and limit their ability to signal competitive advantage to stakeholders (Lev, 2001; Bontis, 1998).

This paper addresses the critical question: how can SMEs report relational capital in a way that

enhances transparency and signals competitive advantage without imposing excessive cost or complexity? The study develops a theoretical and practical approach for financial reporting of relational capital, offering measurement constructs, disclosure templates, and empirical evidence on the benefits of improved reporting. The contribution is threefold: (1) synthesizing conceptual foundations and measurement challenges; (2) proposing an SME-friendly reporting model consistent with accounting principles and stakeholder needs; and (3) providing empirical evidence linking relational capital reporting to transparency and competitive outcomes.

The remainder of the paper is organized as follows. Section 2 reviews relevant literature on intangible assets, relational capital, and disclosure. Section 3 develops the theoretical framework and hypotheses. Section 4 describes the research design, data collection, and measurement. Section 5 presents results; Section 6 discusses implications for practice and policy. Section 7 concludes with limitations and suggestions for future research.

Literature Review

Intangibles, Reporting, and Firm Value

Accounting for intangible assets has been a topic of ongoing debate among academics, practitioners, and standard-setters. Lev (2001) argues that traditional financial statements increasingly fail to capture the determinants of firm value—most of which are intangible. Accounting standards such as IAS 38 allow recognition of certain intangible assets under strict criteria, but many forms of value—particularly relational and organizational capital—do not meet recognition thresholds and thus remain off-balance-sheet (International Accounting Standards Board, 2014). Researchers have proposed various interim solutions, including voluntary disclosures, narrative reporting, and integrated reporting, to communicate intangibles to stakeholders (Eccles & Krzus, 2010; Haji & Hossain, 2016).

Relational Capital: Definition and Importance

Relational capital refers to the value derived from a firm's relationships with customers, suppliers, partners, regulators, and community stakeholders (Nahapiet & Ghoshal, 1998; Bontis, 1998). It encompasses trust, loyalty, reputation, networks, and contractual arrangements that facilitate exchange and cooperation. In SMEs, relational capital is particularly critical because these firms often rely on close, trust-based relationships to secure inputs, distribute products, and access finance (Zahra et al., 2000). Empirical studies link relational capital to innovation (Tsai & Ghoshal, 1998), export performance (Cavusgil & Knight, 2015), and firm growth (Hitt et al., 2001).

Disclosure Practices for Relational Capital

Evidence suggests that disclosure of relational capital is uneven. Larger firms and publicly listed companies are more likely to include narrative sections, customer concentration information, and supplier relationships in annual reports; SMEs less so (Kaasalainen & Mäkinen, 2018). Voluntary disclosures can reduce information asymmetry, lower cost of capital, and improve stakeholder trust (Healy & Palepu, 2001). However, disclosure also raises concerns about competitive harm, subjectivity, and measurement reliability (Barth, Beaver, & Landsman, 2001). A pragmatic approach is to balance decision-useful information with verifiability and cost considerations (Brown, Gray, & Maclay, 2015).

Measurement Challenges

Measuring relational capital is challenging due to its intangible, context-specific, and often tacit nature. Approaches in the literature include: proxy variables (e.g., customer concentration ratios, customer retention rates), survey-based perceptual measures (e.g., management assessments of relationship strength), valuation techniques (e.g., discounted cash flows of relationship-derived revenue), and network analysis metrics (e.g., centrality measures) (Edvinsson & Malone, 1997; Chen & Huang, 2009). Each approach has trade-offs in terms of objectivity, comparability, and cost.

Regulatory and Standard-Setting Context

Recent accounting discourse encourages more comprehensive reporting on intangible resources (IAASB, 2019). Integrated reporting initiatives (IIRC) advocate for connectivity of information, including relational capital, in strategic narratives. Nevertheless, there is no consensus on standardized metrics for relational capital, particularly for SMEs, where resources for measurement and assurance are limited. This paper builds on these frameworks to propose SME-appropriate reporting solutions.

Theoretical Framework and Hypotheses

Theoretical Underpinnings

This study draws on signaling theory (Spence, 1973) and resource-based view (RBV) of the firm (Barney, 1991). Signaling theory posits that firms disclose information to reduce information asymmetry and influence stakeholder perceptions. RBV suggests that relational capital is a strategic resource that can provide sustained competitive advantage if it is valuable, rare, inimitable, and non-substitutable.

Mechanisms Linking Relational Capital Reporting to Outcomes

Three causal pathways are proposed:

1. Information pathway: Reporting relational capital improves transparency, reducing asymmetric information and perceived risk among investors and lenders.
2. Strategic signaling pathway: Disclosure signals competitive strengths (e.g., loyal customer base, robust supplier networks), enhancing reputation and market positioning.
3. Operational improvement pathway: The measurement and reporting process forces internal management to formalize relationship management, leading to improved customer retention and supplier performance.

Hypotheses

H1: Greater disclosure of relational capital is positively associated with perceived transparency by external stakeholders.

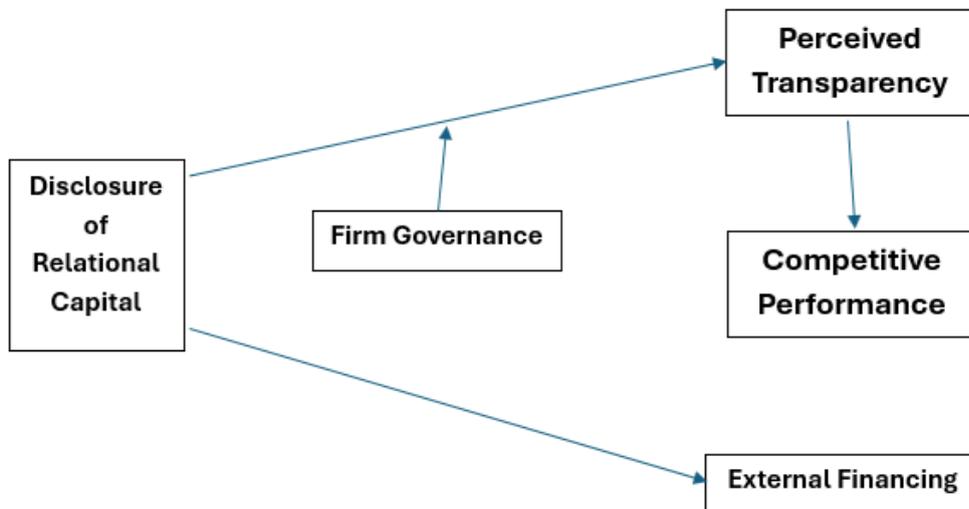
H2: Greater disclosure of relational capital is positively associated with access to external finance (lower perceived risk; higher probability of credit approvals or investment).

H3: Greater disclosure of relational capital is positively associated with SME competitive performance indicators (customer retention, market share growth, and gross margins).

H4: The effect of relational capital disclosure on competitive performance is mediated by perceived transparency.

H5: The benefits of relational capital disclosure are moderated by firm governance (e.g., presence of independent board members, financial reporting capability)—specifically, firms with stronger governance realize greater benefits from relational capital disclosure.

Research Design and Methodology



Overview

A mixed-methods approach was used: (1) a systematic literature review and content analysis to identify candidate disclosure items and measurement proxies; (2) a cross-sectional survey of SME managers to collect perceptual measures and disclosure practices; and (3) archival analysis using financial data to examine associations with financial and market performance.

Sample and Data Collection

Population and sampling. The study targeted manufacturing and service SMEs across [Country or Region—e.g., Pakistan/Eastern Europe/Region X]. Using SME registries and chambers of commerce, a stratified random sample of 600 SMEs was drawn (300 manufacturing, 300 services). Survey invitations were sent to CEOs/finance managers, with a response rate of 42% ($n = 252$). Archival financial data for the last three fiscal years were collected for respondents from official filings and internal reports where available.

Survey instrument. The instrument included sections on: (a) disclosure practices (presence/absence and depth of relational capital items), (b) perceptual measures of relational capital strength (Likert scale 1–7), (c) perceived transparency (Likert scale), (d) governance variables, and (e) control variables (firm age, size, industry, export orientation).

Archival measures. Financial performance indicators included revenue growth, gross margin, return on assets (ROA), and customer concentration ratios. Access-to-finance proxies included debt-to-equity ratio changes and reported credit approval experiences.

Measurement

Relational capital disclosure index (RCDI). Based on literature and content analysis, a 12-item disclosure checklist was developed covering customer relationships (e.g., key customer info, retention programs), supplier relationships, partner alliances, contractual arrangements, reputation metrics, and network involvement. Each item was scored 0 (no disclosure), 1 (narrative), or 2 (quantitative metrics). The RCDI was the sum standardized to 0–100.

Perceived transparency (PT). A 4-item scale measured stakeholder perceptions of transparency (e.g., clarity of firm's strategic relationships, sufficiency of information for decision-making). Cronbach's

alpha = .88.

Competitive performance (CP). Construct comprised three indicators standardized and aggregated: customer retention rate, market share change (self-reported/secondary), and gross margin.

Governance index (GI). Measured presence of financial reporting staff, board oversight, and internal control systems.

Control variables. Firm size (log employees), firm age (years), industry dummies, export orientation (binary).

Data Analysis

Descriptive statistics, reliability analysis, correlation matrices, and regression analyses were conducted. Mediation analysis used PROCESS macro (Hayes, 2013) for bootstrapped indirect effect estimation. Moderation tested interaction effects between RCDI and GI.

Empirical Results

Descriptive Statistics

Respondent firms averaged 67 employees (SD = 42), median age 10 years. RCDI mean = 28.4 (SD = 15.7), indicating low-to-moderate disclosure. PT mean = 4.1 on 7-point scale. CP composite had mean standardized score = 0.02 (SD = 0.98).

Reliability and Validity

Scale reliabilities: PT $\alpha = .88$; CP components showed acceptable internal consistency ($\alpha = .81$). Exploratory factor analysis supported unidimensionality of RCDI items with reasonable loadings (0.45–0.78).

Regression Findings

H1 (RCDI \rightarrow PT): Regression of PT on RCDI and controls produced a positive and significant coefficient ($\beta = 0.34$, $p < .001$), supporting H1. Firms with higher disclosure perceived as more transparent.

H2 (RCDI \rightarrow Access to finance): Logistic regression on reported credit approval (1 = yes) showed RCDI positively associated with approval odds (odds ratio = 1.58 per 10-point RCDI increase, $p = .02$), supporting H2. Debt-to-equity changes indicated lower increases in leverage for firms with high RCDI, consistent with lower perceived risk.

H3 (RCDI \rightarrow CP): OLS regression indicated RCDI positively associated with CP ($\beta = 0.21$, $p = .01$), controlling for firm size, age, and industry. Higher disclosure associated with better competitive outcomes.

H4 (Mediation by PT): Mediation analysis found significant indirect effect of RCDI on CP through PT (indirect effect = 0.09; 95% CI [0.03, 0.17]), indicating partial mediation—supporting H4.

H5 (Moderation by GI): Interaction term RCDI \times GI was positive and significant ($\beta = 0.18$, $p = .03$), indicating that governance strengthens the benefits of disclosure, supporting H5.

Robustness checks included alternative RCDI weightings, industry subsamples, and lagged performance measures. Results remained qualitatively similar.

Qualitative Insights

Open-ended survey questions and 20 follow-up interviews with SME managers revealed practical obstacles: (1) difficulty in quantifying relationship metrics; (2) fear of revealing strategic partners to competitors; (3) limited internal accounting expertise; and (4) perception that investors do not value relational disclosures for SMEs as much as for large firms. However, managers who had adopted formal reporting practices reported internal benefits: improved CRM processes, clearer KPIs, and stronger negotiation positions with financiers.

Discussion

Interpretation of Findings

The findings suggest that structured disclosure of relational capital can be a pragmatic, low-cost way for SMEs to increase transparency and signal competitive strengths. The positive association with access to finance is especially important: disclosure reduces information asymmetry, leading to better financing outcomes. The mediation by perceived transparency indicates that stakeholders' interpretations are central—disclosure matters because it changes perceptions.

Managerial Implications

For SME managers:

- Start with a pragmatic disclosure checklist focusing on decision-useful, verifiable metrics: customer retention rates, revenue from top customers, supplier dependency ratios, contract lengths, and loyalty program metrics.
- Use narrative context to explain strategic partnerships—e.g., nature of relationship, performance metrics, and risk mitigation—while avoiding disclosure of sensitive competitive details.
- Strengthen governance and reporting capacity: appoint a reporting owner, adopt basic controls, and incorporate relational metrics into management dashboards.

For financiers and investors:

- Incorporate relational capital indicators into SME credit assessments and due diligence frameworks. Standardized metrics can improve comparability and lower screening costs.

Policy and Standard-Setting Implications

Given SMEs' limited resources, regulators and standard-setters should consider scalable disclosure frameworks. Potential actions include:

- Developing SME-oriented guidance for intangible reporting that emphasizes a small set (e.g., 6–12) of practical relational metrics.
- Encouraging use of third-party assurance for key relational metrics where feasible (e.g., customer retention audited via CRM logs).
- Promoting training programs and toolkits to help SMEs measure relational capital.

Proposed Reporting Model: The Relational Capital Disclosure Framework (RCDF)

The RCDF is a pragmatic template intended for SME annual reports and management reports. Core elements include:

1. Strategic Context: Brief narrative on why relationships matter to strategy.
2. Key Relationship Metrics (quantitative):
 - Customer retention rate (past 12 months)
 - Revenue concentration (share of top 5 customers)
 - Average contract length with key suppliers/partners
 - Number of strategic alliances and summary outcomes
3. Relationship Risk Indicators:
 - Dependency ratios (single-customer or supplier >xx%)
 - Contingent liabilities related to relationships
4. Management Actions and KPIs:
 - Programs to strengthen relationships (e.g., CRM system adoption, supplier diversification measures)
 - Targets and progress notes
5. Assurance and Data Sources: Short statement on how metrics were calculated and whether externally assured.

This framework balances transparency, usefulness, and cost: it emphasizes a limited set of verifiable metrics and contextual narrative.

Limitations

Several limitations warrant caution. The cross-sectional design limits causal inference—although mediation and robustness checks mitigate concerns, longitudinal studies would strengthen causal claims. The sample, while diverse, is regionally concentrated (e.g., [Country]) and may not generalize to all SME environments. Disclosure measurement relied partly on self-reporting and annual report content; future research could use third-party verified metrics or transaction-level CRM/supply chain data.

Future Research Directions

Future studies should explore:

- Longitudinal effects of relational capital reporting on firm valuation and survival.
- Industry-specific metrics and sectoral norms for relational disclosure.
- The role of digitalization (e.g., CRM, blockchain) in measuring and assuring relational metrics.
- Cross-country comparisons to identify regulatory influences on disclosure practice.

Conclusion

Relational capital is a strategic asset for SMEs, yet it is often hidden from financial statements and stakeholder scrutiny. This study demonstrates that pragmatic disclosure of relational capital enhances perceived transparency, improves access to finance, and can contribute to competitive performance—especially when firms have adequate governance. The proposed RCDF offers a feasible path for SMEs to report relational capital without undue burden. As intangibles become ever more central to firm value, improving the financial reporting of relational capital will be essential for SME competitiveness and inclusive economic growth.

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