

Governance, Corporate Reputation and Intellectual Capital Disclosure

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This study focuses on developing a conceptual framework for examining determinants that influence intellectual capital reporting and relies on a critical review of the literature. Indexed journals are reviewed, and evidence is drawn to develop a model examining possible determinants of intellectual capital reporting. Data for the study was gathered from the annual reports of 40 banks listed on the Dhaka Stock Exchange. Findings of the paper established a corporate reputation as a significant positive determinant of IC disclosure. Regulators will be benefited from the model as it can provide guidance in implementing uniform guidelines for IC disclosure. The conceptual framework developed in the paper is first of its kind and thus contributes to the body of IC literature.

Keywords: Intellectual Capital, Governance, Voluntary Reporting, Reputation.

JEL Classification: M41, O34

1. Introduction

In knowledge-based economy, organisations tend to use two distinct sources of profit making and value creation. Nowadays companies do not primarily invest in fixed assets, but in intangible assets that play an important role in determining the value of a company. As financial globalisation proceeds, international financial reporting standards are increasingly becoming important integration. Intellectual Capital theory considers such key companies' resources as employee knowledge, information systems, relationships with suppliers and customers, and management. It combines existing achievements in different areas, such as intangible asset evaluation, the theory of competitive advantage, resource-based approach to the theory of the firm, and human capital.

The performance measurement system is heavily inclined towards financial and physical aspects of the company and thus lacks relevant information regarding the performance of the intangible assets or intellectual capital efficiency. As a result, knowledge on the impact of intellectual capital on the corporate performance measurement system or the overall performance of the company is insufficient. Intellectual capital reporting provides a foundation to integrate the corporate sustainability reporting and disclosure to measure the performance.

Past studies have focused on the intellectual capital reporting practices (Guthrie et al., 2004; Lev, 1999; Striukova, Unerman and Guthrie, 2008) in various parts of the world, but only a number of studies have identified the determinants of voluntary intellectual capital reporting

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in the company financial reports (Yan 2017; Brügger et al. 2009). In the process of exploring the determinants of intellectual capital reporting, only Yan (2017) have very recently discussed the impact of governance on IC reporting. Thus, this study was aimed at reducing the research gap by developing an IC reporting framework with integrated governance mechanism to generalise the findings of Yan (2017). The antecedent and outcome model of IC reporting also contributes to the IC literature by introducing corporate reputation as a determinant of voluntary IC reporting that could be achieved through an increase in IC disclosure and improved governance mechanism.

This study aims at analysing the voluntary disclosure of intellectual capital (IC) items in the annual reports of intellectually intensive industries. Following the study of Oliveira, Rodrigues, & Craig (2010), a framework is developed to identify the antecedents of IC reporting. Agency theory and legitimacy theory are introduced in developing the conceptual framework of IC reporting. Findings provided by the study validate the propositions of both agency and legitimacy theory and allow board members to understand the link between corporate reputation and IC disclosure. This paper is divided into three distinct parts. First, relevant literature on IC reporting is critically reviewed along with theoretical perspective to develop the conceptual framework. In the second part, hypotheses are developed followed by a discussion on methodological issues. The final section of the paper discusses results and concludes with direction on future research related to intellectual capital disclosure.

2. Literature Review

IC reporting has been the subject of research for more than 15 years, as reviewed by Dumay (2014) and Guthrie et al. (2012). A remarkable number of IC reporting studies exist, focusing on voluntary IC reporting in various research settings, as discussed by Dumay & Cai (2014). The IC (both human and structural) is viewed by resource-based theory as being a strategic resource in the same way as capital employed (physical and financial) is viewed as a strategic resource. This theory considers that companies gain competitive advantage and superior financial performance through the acquisition, holding and efficient use of strategic resources.

However, many authors such as Youndt et al. (2004) underline that capital employed (physical and financial) is not strategic because it simply constitutes a generic resource. It is precisely IC that is viewed as being a strategic resource allowing the company to create value for the stakeholders. For these authors, a resource is considered to be strategic when it distinguishes itself from others by the difficulty of imitation, substitution and by its imperfect mobility.

This point of view is consistent with Reed et al. (2006) who recently developed an IC-based theory. Reed and her colleagues view their theory as a mid-range one because it represents one specific aspect of the more general resource-based theory. Although they have the same objective, to explain corporate performance by the effective and efficient use of a company's resources, the IC-based theory considers IC as being the only strategic resource to allow a company to create value. This theory does not break away from its origins and is always analysed along with resource-based theory.

Intellectual capital Research (ICR) has evolved over the past two decades in what Guthrie et al. (2012) describe as three distinct stages. The first stage of ICR has its origins in the late 1980s and into the 1990s and according to Petty & Guthrie (2000) helped develop a "framework of intellectual capital". The second stage of ICR can be defined as a stage where

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approaches to measuring, managing and reporting IC came to the fore and to gather evidence in support of its further development (Petty & Guthrie 2000). During this stage, different classifications were created which helped to define and group different methods of IC evaluation (Ricceri, 2008). By the mid-2000s more than 50 methods were created which either helped to define IC as a whole or define different elements of IC, and the list keeps growing.

Bontis et al. (2000) add another perspective to IC from the knowledge-based view of the firm. They discuss dynamics of IC in the management process and further build on this idea about IC reporting. One of their main conclusions is that a company's IC focus changes with its maturing progress as maturing companies establish a stock of knowledge, representing an important part of IC.

Shakina & Barajas (2015) proposed three strategic profiles of firms regarding intangibles. They demonstrated that investments in intangibles allow a company to be better off, even in a period of crisis. Martínez-Torres (2014) proposed a procedure for identifying the intangible assets that generate value to knowledge-intensive organisations. Olander et al. (2015) studied how human resources create the basis for continuing innovation and subsequent firm performance in knowledge-intensive industries. Massingham & Tam (2015) examined the relationship between HC (Human Capital) and value creation and employee reward. The reporting of human capital indicators informs stakeholders the knowledge management activities of an organisation. Mouritsen et al. (2001) helps to ameliorate employee morale and improves understanding of the crucial factors for growth and development (Petty and Guthrie 1999). Failure to value an intangible can undervalue a company (Lev 1999).

The reporting of human capital indicators informs stakeholders the knowledge management activities of an organisation (Mouritsen et al. 2001), helps to ameliorate employee morale and improves understanding of the crucial factors for growth and development (Petty & Guthrie 2000). Failure to value an intangible can undervalue a company (Lev 1999). Consequently, organisations and investors are trying to gain new understandings into the underlying terms, concepts, and complex mechanisms of human capital indicators. Bowen et al. (1997) suggested that a system of indicators could be integrated into stockholder value analysis to provide a long-term profitability perspective. However, much of what has been done to date is for managerial purposes rather than for external reporting. For this reason, executives have a better knowledge of how human capital indicators are measured than investors.

Ramezan (2011) seeks to investigate the relationship between organic organisational structure and intellectual capital improvement. Researchers show that the organic structure and intellectual capital have a strong relationship but this relationship has not been examined systematically. The results support the view that organic structure has a positive impact on intellectual capital. Therefore, the organic structure can improve intellectual capital in the organisation. The study helps managers to design flexible and dynamic organisational structures to enhance the intellectual capital in the organisation and increase the ability to complete.

Alshubiri (2013) analysed the relationship between human capital investment and corporate financial performance of 11 Industrial sectors listed in Amman Stock exchange from 2005 to 2011 where he used various financial performance indicators like, EPS, ROE, DPS, and he concluded that there was a high degree of positive relationship between Human capital investment and corporate financial performance. The study recommends that industrial

companies should strengthen and stimulate the concept of human capital and the need for developing administrative innovation program.

Salman & Tayib (2012) presents a statistically significant relationship between the elements of the components of IC and the performance of companies where the relationship was a strong element of HC more of them than the other variables of the components of IC. Much of the prior literature examining factors influencing, or motivations for, sustainability reporting has examined aspects of reporting without reference to the internal organisational context, including the processes of reporting and attitudes which influence decision-making regarding reporting (Adams et al., 2005).

3. Theoretical Perspective

Agency theory suggests that the potential for agency costs arises because of conflicts of interests between contracting parties (Jensen and Meckling 1976). The concept of misalignment of interests between principal and agent was introduced by Jensen & Meckling (1976) which suggests a potential conflict that inherently reduces the value of the firm as an economic entity. Research based on agency theory has provided valuable insights into the determinants corporate disclosure. Agency theory predicts that a greater extent of disclosures is expected since the adoption of more governance mechanisms will strengthen the internal control of companies and reduce information asymmetry and opportunistic behaviour among agents. Focusing on voluntary disclosures, management's incentive to engage in this activity has been shown to vary with various corporate governance mechanisms such as audit committee (Akhtaruddin & Haron 2010), board size (Cheng & Courtenay 2006), board independence (Cheng & Courtenay 2006) and external audit (Darmadi 2013).

Institutional isomorphism puts constraints and pressure on a reporting firm to imitate others and find legitimacy (DiMaggio & Powell 1983). Legitimacy is a generalised perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions. O'Dwyer (2002) identified that prime motive for sustainability reporting among senior executives among Irish public listed companies was to enhance corporate legitimacy. Adams & Whelan (2009) relates sustainability reporting to simplistic motivations such as wealth maximisation, reputation risk management and maintenance of organisational legitimacy. Archel et al. (2009) choose to match political realities and link sustainability reporting with legitimacy theory through a longitudinal disclosure analysis of the annual report and media disclosures between a multinational automotive company in Spain, employee and state and reports that problems with sustainability reporting are left unresolved.

4. Hypothesis Development

The primary objective of this paper is to determine whether corporate governance mechanisms are associated with a firm's voluntary intellectual capital reporting. Firms' Disclosure behaviours have already linked with governance mechanisms by propositions of agency theory (Jensen & Meckling 1976). Corporate governance mechanisms are involved in monitoring and determining a firm's overall information disclosure policy (Kelton & Yang 2008). The role of governance mechanisms in determining disclosure policy may be either complementary or substitutive (Ho & Wong, 2001). Several governance mechanisms have been studied in the past literature that has a significant association with the extent and

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quality of corporate financial disclosure. Among them, board size (Cheng & Courtenay 2006), board independence (Chau and Gray 2010), audit committee (Johl et al. 2013) and external auditing (Firth 1979) have made their mark in the governance literature. The influence of governance mechanism on voluntary IC reporting has not yet been established.

Corporate reputation is a valuable intangible asset for companies and can be accumulated through effective implementation of corporate governance mechanisms. The concepts of corporate governance and corporate reputation both involve stakeholders. While corporate reputation depends on the perception and judgement of the attitude toward a corporation's actions, which implies the certain actions are more desirable for certain stakeholder group than the others, corporate governance aims at managing and controlling corporate actions in general and as well as toward specific stakeholders. Ljubojević & Ljubojević (2008) dealt with the mutual relations of corporate governance and corporate reputation and identified the significant impact of effective governance mechanisms, transparent reporting in building corporate reputation. There is lack of significant evidence to establish a clear link between governance and corporate repetition, and non-existent evidence exists in the IC reporting literature.

Regarding voluntary disclosure by listed firms in Singapore, Cheng & Courtenay (2006) found the non-significant influence on a large board. Yermack (1996) found that firm valuation is negatively related to the size of the board. Larger boards can provide increased director collegiality through individual specialities from a wide diversity. However, empirical evidence for a positive influence of board size on corporate disclosure derived from developed countries may not be generalizable for developing countries. Lipton and Lorsch (1992) argue that agency problem can arise in large boardrooms where directors are less likely to function effectively, which weakens their monitoring role. Findings provided by Cheng & Courtenay (2006) may not be sufficient as they have studied the extent of voluntary internet financial reporting.

Board composition and independence are closely linked to the involvement of independent, outside directors in the board. Fama & Jensen (1983) suggests that board composed of a higher proportion of independent directors have greater control over managerial decisions. Independent directors are found to have both positive (Chau & Gray 2010; Cheng & Courtenay 2006; Ho & Shun Wong 2001) and negative (Eng & Mak 2003) association with voluntary disclosure practices among listed companies. Eng & Mak (2003) explained the negative association by pointing to the fact that outside directors may act as a substitute for monitoring through public disclosure.

Carcello & Neal (1997) find a negative relationship between the percentage of executive and grey directors members on the audit committee and the likelihood of receiving an unqualified opinion. Williams (2002) found a positive association between the proportion of independent directors and firm's discretionary decisions to increase the level of independence on the audit committee above the suggested minimum. Voluntary disclosure is found to have a significant association with the existence of an audit committee among listed companies in Hong Kong (Ho & Shun Wong 2001).

The use of large external auditors motivates voluntary disclosure among listed companies. Larger audit firms have a stronger incentive to maintain their independence as their reputation is in line which could result in more stringent and extensive disclosure standards (Malone et al. 1993). The positive association between large audit firms and disclosure have been empirically established by Inchausti (1997). However, Xiao et al. (2004) found no

significant influence of large audit firms involuntary internet-based disclosure by listed Chinese companies which are similar to the findings of Gul & Leung (2002). Improvement on voluntary reporting through the appointment of top audit firm has not yet become a fact as few studies focusing on this issue have revealed mixed findings. Also, the unit of analysis for these studies was different that contributed toward mixed findings. Thus, the following hypotheses are developed to establish the impact of improved governance mechanism in building corporate reporting:

H_{1a}: Board size has a negative impact on corporate reputation.

H_{1b}: Board independence has a positive impact on corporate reputation

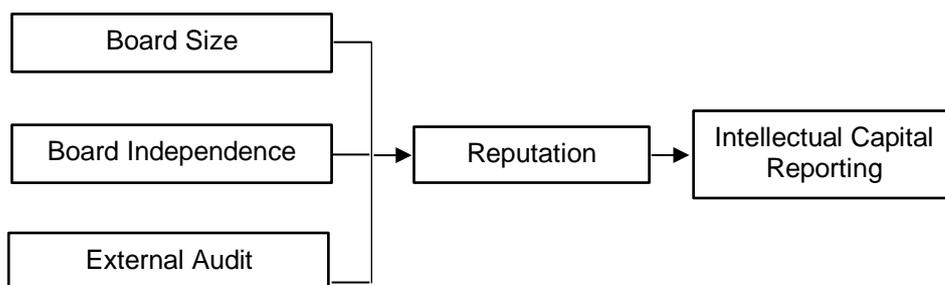
H_{1c}: External auditor reputation has a positive impact on corporate reputation.

O'Dwyer et al. (2011) noted legitimacy of the sustainability reports could not be attained for the long term unless there is demand from stakeholders. Thus, the need for uniform standards is advocated by academicians and practitioners. Reporting intellectual capital information through sustainability report can enhance stakeholder interest and allow companies to enhance reputation. Voluntary disclosure has already been linked with a corporate reputation in light of the propositions of legitimacy theory (Archel et al. 2009). Amran & Ooi (2014) indicates that the most important reason for a business to initiate voluntary reporting is to protect their brand and reputation. Shell was among the first large corporate to issue a corporate social responsibility report as a result of stakeholder pressure to suppress the allegation of human rights violations in Nigeria. Thus, the following hypothesis is formulated:

H₂: Corporate reputation has a positive impact on the extent of IC reporting.

5. Conceptual Framework

Figure 1: Conceptual framework for Intellectual Capital Reporting



The conceptual framework provided in Figure 1 is developed based on the propositions of agency and legitimacy theory. Both internal and external governance mechanisms are incorporated to measure the overall governance compliance of listed companies. Board size has been studied as an important indicator of firms voluntary disclosure). Boards with a majority of independent directors have significantly higher level of voluntary disclosure than firms with balanced boards (Cheng & Courtenay 2006). Thus, board independence is included in the model to measure its significance in intellectual capital reporting in sustainability reports. Finally, the reputation of an external audit firm is incorporated into the model due to its significance in explaining voluntary disclosure (Xiao et al. 2004).

6. Methodology

6.1 Disclosure Index Development

The study has utilised a disclosure indexed to measure the extent of intellectual capital reporting. A score of 1 is attached to items disclosed in the sustainability reports while 0 is provided for non-disclosure. Performance indicators relating to environmental, labour practices, product responsibility, human rights and society are included in the index to measure the level of sustainability reporting among listed companies.

Intellectual Capital Disclosure index is adapted from the study of Oliveira et al. (2010). IC disclosure index includes 88 items that firms could report in corporate reports. IC disclosure items are divided into six segments including Strategy, Processes, Technology, Innovation, Research and Development, Customers and Human Capital. The total disclosure sum will be calculated as:

$$ICI = \frac{\sum_{i=1}^m d_i}{m}$$

Where,

$d_i = 0$ or 1 , as follows:

$d_i = 0$, if disclosure item is not found;

$d_i = 1$, if disclosure item is found; and

$m =$ the maximum number of items a firm can disclose in the sustainability report (i.e. 88 items).

6.2 Data Description

Data for the current study are collected through the content analysis of the audited annual report of 2016 for forty commercial banks (31 conventional and 9 Islamic) listed in Dhaka Stock Exchange. Foreign commercial and state-owned banks were not included in the study. Convenience sampling method was used to select banks for the study.

Table 2 provides a list of variables provided in the conceptual model with their operational definition. Reputation was measured with the credit rating score of listed companies provided by reported credit rating agencies.

The conceptual model includes a total number of four variables. Patten (2002) indicates that larger boards are more visible and contributes toward voluntary reporting. Malik et al. (2014) argue that a large board size can enhance the bank performance. A positive relationship between strong environmental performance and Board independence is reported in Uyar et al. (2013). The positive association between large audit firms and disclosure provided by Inchausti (1997) have led toward the inclusion of this variable in the conceptual model.

Table 1: Variable Definitions

Variables	Abbreviations	Definitions
Dependent		
Reputation	R	Credit Rating score.
Independent – Governance Compliance		
Board Size	BS	Number of directors on board
Board Independence	BI	Number of independent directors on board.
External Audit	EA	1 if audited by the big 5 audit firms, 0 otherwise.
Mediator		
Intellectual Capital Reporting	ICR	Total score obtained from the Intellectual Reporting Index.

7. Findings and Discussion

Table 2 provides the descriptive statistics of the five variables included in the conceptual model of the study. Board size has a mean score of 15.70 indicating the involvement of a large board in the banking industry. The presence of independent members of the board was very low with a mean score of 1.075. It was also noticed that majority of the banks are audited by reputed external auditors to ensure the reliability of the annual reports. Intellectual capital reporting has an average score of 25.4 percent. While a minimum score of 0 was obtained, the maximum score of 85.20 percent indicates that few banks provide on the emphasis on IC reporting in their annual reports. Finally, the reputation of banks was extracted from the annual reports using the credit rating guidelines provided by Bangladesh Bank. Mean score of 3.025 indicates that the selected sample of banks has an average rating of BBB on long-term rating category. None of the selected banks has an AAA rating which associates a risk weight of 20 percent. Correlation statistics provided in Table 3 indicates that none of the independent variables is highly correlated with each other while a reasonable amount of correlation exists between independent and dependent variables. Thus, the study does not suffer from multicollinearity issue.

Table 2: Descriptive Statistics

Variables	Mean	Standard Deviation	Min	Max
Board Size	15.70	5.358	6.00	32.00
Board Independence	1.075	1.212	0.00	4.000
External Auditor	0.625	0.484	0.00	1.000
Intellectual Capital Disclosure	0.254	0.250	0.00	0.852
Reputation	3.025	1.440	0.00	5.000

Table 3: Correlation Statistics

	BS	BI	EA	ICR	R
BS	1.000				
BI	-0.060	1.000			
EA	-0.226	0.083	1.000		
ICR	-0.211	0.300	0.191	1.000	
R	-0.579	-0.049	0.072	0.248	1.000

Discriminant validity of the study was determined using the Heterotrait Monorail Ratio of Correlations (HTMT Correlations) provided by Smart PLS 3.0. The approach provided by

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Fornell and Larcker (1987) lacks reliability in detecting discriminant validity in common research situations (Henseler et al. 2015). HTMT correlation score should be below 0.90 for each set of correlations. Table 3 ensures discriminant validity for the study as none of the score is found to exceed the recommended level. Table 4 provides model fit statistics. Chi-square statistics and Normed Fit Index (NFI) satisfies the recommended range and ensures the statistical fitness of the developed model.

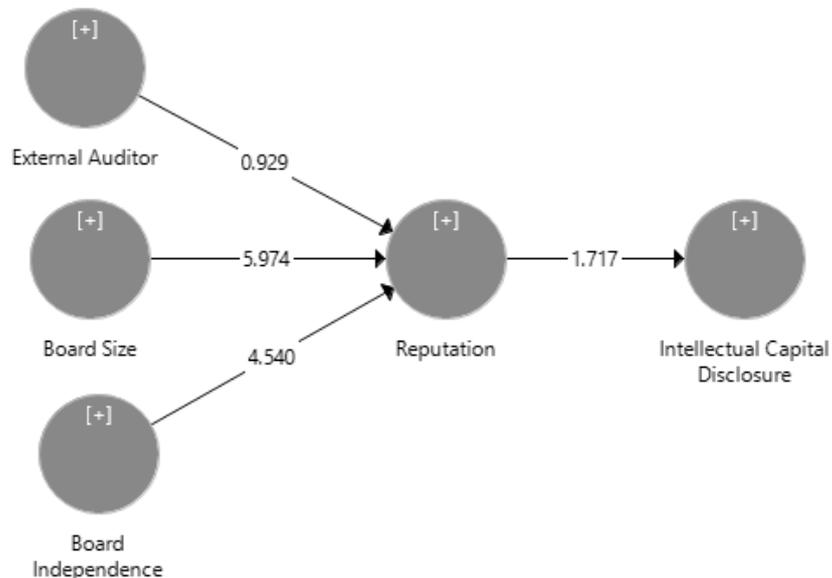
Table 4: Discriminant Validity (HTMT Correlations)

	BI	BS	EA	ICR	R
BI					
BS	0.062				
EA	0.176	0.226			
ICR	0.198	0.300	0.049		
R	0.471	0.579	0.300	0.248	

Table 5: Model fit statistics

Criteria	Values	Recommended Values
SRMR	0.06	0.08 – 0.10
D_LS	0.46	p>0.05
D_G	0.02	p>0.05
Chi-Square	3.668	Lower is better
NFI	0.907	Closer to 1

Figure 2: Structural Equation Modelling Results



Structural equation modelling was performed using SMART PLS 3.0 and results are provided in Figure 2 and Table 6. The study has hypothesised four relationships. First, board size was hypothesised to have a negative impact on corporate reputation. Yermack (1996), Jensen (1993) and Lipton and Lorsch (1992) concluded that larger board leads to poor

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communication that has a negative impact ($\beta=-0.529$, $p<0.001$) on corporate reputation. Similar findings were achieved by the current study as thus H_{1a} was accepted. Board independence was hypothesised to have a positive impact on corporate reputation. Such relationship is statistically proven as board independence was found to have a significant positive relationship ($\beta=0.420$, $p<0.001$) with reputation. These results validate the findings of Kumaran and Thenmozhi (2015) and Bravo et al. (2015). Thus, H_{1b} is accepted.

While Winston (2002) have advocated the importance of external audit in enhancing corporate reputation, such relationship was not established in the study due to a non-significant relationship. Thus, H_{1c} is rejected. Finally, corporate reputation was hypothesised to have a positive impact on the level of intellectual capital reporting in corporate reports based on the propositions of legitimacy theory. Reputation was found to have a statistically significant positive impact ($\beta=0.248$, $p<0.010$) on IC disclosure. This study found that reputable companies voluntarily disclose higher amount of IC related information to ensure the legitimacy of their operation among the stakeholders. These findings validate the propositions of legitimacy theory and contribute to IC literature.

Table 6: Path Coefficients

Paths	β	T-Stat	P-Value
Board Independence→Reputation	0.420	4.540	0.000**
Board Size→Reputation	-0.529	5.974	0.000**
External Auditor→Reputation	0.107	0.929	0.353
Reputation→Intellectual Capital Disclosure	0.248	1.717	0.075*
Adjusted $R^2 = 0.497$			

*Note: *, ** and *** represents significance at 10%, 5% and 1% respectively*

7. Conclusion

Intellectual capital reporting has become a cornerstone of corporate communications for listed companies in developed countries. Various innovations and progress have been made in the field of Intellectual reporting. Still, the importance of standardised reporting practices that could be followed by both developed and developing countries is required. This study provides a basis for measuring the impact of internal and external governance mechanisms toward influencing voluntary IC disclosures in corporate reports. The conceptual antecedents and outcome model extends IC reporting literature by proving a framework to investigate the interrelationships between governance, IC reporting and corporate reputation. Empirical evidence provided by the study validates the propositions of agency and legitimacy theory. This study advocate for a smaller board and increase of independent members on the board that can lead to an increase in corporate reputation. Corporate reputation leads to better disclosure of IC information in the corporate reports. Policy makers will be benefited from these findings in implementing appropriate governance mechanism to build corporate reputation among stakeholders who will be benefited from the greater transparency. The influence of corporate reputation on IC disclosure established by the study contributes to IC literature. Findings provided by the study are limited to a convenience sample of selected banks and thus could not be generalised for other industries. A longitudinal study could provide more insights on the importance of structured governance mechanisms incorporate IC reporting. Despite some limitations, this study contributes to the IC literature and provides valuable evidence to the stakeholders and management regarding the importance of IC disclosure that could lead to enhanced corporate reputation and provide companies with a competitive edge.

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