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Intellectual capital disclosures and corporate governance: An empirical examination

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ABSTRACT

Empirical examinations of the links between corporate governance and intellectual capital are underresearched, particularly from the context of emerging economies where corporate governance mechanisms tend to be largely ceremonial due to family dominance. This study aims to address this gap in the intellectual capital disclosure (ICD) literature by undertaking an empirical examination of the relationship between corporate governance and the extent of ICD of Bangladeshi companies. *Inter alia*, the key findings of this study suggest that there is a non-linear relationship between family ownership and the extent of ICD. This research also found that foreign ownership, board independence, and the presence of audit committees are positively associated with the extent of ICD. Conversely, family duality (i.e., where the positions of CEO and chairperson are occupied by two individuals from the same family) is negatively associated with the extent of ICD.

1. Introduction

In today's knowledge-based economies, intellectual capital (in addition to financial and physical capital) plays a significant role in the value creation process of organizations. It is argued that the success of many 21st century organizations lies in their ability to unlock and exploit their intellectual capital to obtain maximum "organizational advantage" (Keenan & Aggestam, 2001; Nahapiet & Ghoshal, 1998). Keenan and Aggestam (2001) were among the earliest authors to identify conceptual links between corporate governance and intellectual capital. They argued that decision makers in charge of the corporate governance of an organization have a "fiduciary responsibility" to utilize the full advantage of intellectual capital, in addition to financial and physical capital. However, empirical knowledge in relation to the conceptual link between corporate governance and intellectual capital is limited. This study aims to contribute to the field of research on intellectual capital disclosure (ICD) (see, for example, Cerbioni & Parbonetti, 2007; Hidalgo, García-Meca, & Martínez, 2011; Li, Pike, & Haniffa, 2008) by examining the relationship between various corporate governance attributes and the extent of ICD.

In one of the earliest empirical studies on European biotechnology, Cerbioni and Parbonetti (2007) found that board structure, independence, and chief executive officer (CEO) duality (i.e., when the same individual is both the CEO and chairperson of the board) are related to ICD. Subsequently, in the United Kingdom, Li et al. (2008) confirmed these relationships with the exception of CEO duality. It appears that the study of Hidalgo et al. (2011) is the only empirical study that explored the relationship between corporate governance and the extent of ICD in a developing country (i.e., Mexico). They also introduced a new corporate governance attribute, that is, family ownership. Their findings suggested that family ownership does not influence the extent of ICD in Mexican companies. One possible reason for this result is that Hidalgo et al. (2011) did not test for a non-linear relationship between family ownership and the extent of ICD; however, this relationship can be established via a quadratic specification of family ownership (which was undertaken in this paper).

This study was conducted in Bangladesh. Scarce empirical evidence exists in respect of the relationship between corporate governance attributes and the extent of ICD.[4] Further, for the most part, previous Bangladesh studies have been descriptive in nature and used relatively small samples; for example, Ali, Khan, and Fatima (2008) found that ICD is mostly disclosed in a narrative form in annual reports and concluded that Bangladeshi companies do not have a positive approach to reporting ICD. Similarly, Khan and Khan (2010), Nurunnabi, Hossain, and Hossain (2011), and Rashid (2013) found that Bangladeshi companies provide limited ICD in annual reports, as it is not a mandatory requirement to report on this in Bangladesh. In a recent study in the pharmaceutical industry, Abhayawansa and Azim (2014) found that

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[4] Appendix I summarizes the features of previous ICD studies in Bangladesh.

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companies did not adopt a consistent framework for ICD and did not properly measure and manage their ICD.

This research was conducted in Bangladesh, as it provided an interesting context for the study. The corporate context of Bangladesh is characterized by relatively small capital market, small firm size, and family-dominated ownership structures. Like many other emerging economies, Bangladesh has adopted a Western-style corporate governance model that requires greater board independence, separation of the CEO and chairperson, and audit committees. In 2006, the Bangladeshi Securities and Exchange Commission (SEC) issued a “Corporate Governance Notification” (SEC, 2006) that provides guidelines for corporate governance practices by listed companies on a “Comply or Explain basis.”[5] However, given the traditional nature of its society (Uddin & Choudhury, 2008), and in circumstances where family ownership is the major form of business in Bangladesh, the efficacy of such corporate governance mechanisms could be compromised. Indeed, previous research (Sobhan & Werner, 2003) has reported that due to family dominance, corporate governance mechanisms tend to be largely ceremonial.[6] Additionally, there are no legislative guidelines for ICD in Bangladesh.[7] Thus, the influence of corporate governance dynamics on ICD may be different in developing countries such as Bangladesh (Rashid, 2013).

This study can be distinguished from previous research and contributes to the literature in a number of ways. First, while exploring the relationship between corporate governance attributes and ICD, it also tests the effect of family ownership on ICD (a relationship which has been understudied in the previous ICD research, but is significant in the context of Bangladesh). In this respect, the non-linear relationship between family ownership and ICD is examined. Second, this study is the first study in the ICD literature to consider the effect of family duality, which is very common in emerging economies, on ICD. Third, to date, the majority of studies have examined the effect of corporate governance attributes on ICD in a Western socio-political context; however, this study focuses on an emerging market, characterized by weak institutional framework and a high concentration of family ownership. Finally, the findings of this study increase understanding in relation to corporate governance attributes and ICD practices and extend the findings of previous descriptive Bangladeshi studies that mainly focused on the extent and content of ICD.

2. Literature review and hypotheses development

In this literature review section, previous research on the relationship between corporate governance and ICD is considered. This section aims to contribute to the stream of ICD literature that examines the relationship between corporate governance and ICD. Based on this discussion, six hypotheses were developed for testing.

2.1. Family ownership

It is argued that agency problems, characterized by a conflict of interest between owners and managers (hereafter referred to as “Type I” agency problems), are less of an issue in family-owned organizations (Anderson & Reeb, 2004). However, substantial agency problems may occur in family-owned organizations attributable to conflict between controlling family owners and minority shareholders (hereafter referred to as “Type II” agency problems) (Villalonga & Amit, 2006). Given the absence of Type I problems in family-owned organizations, family owners can mitigate agency problems. Concentrated ownership motivates family members to maximize the wealth of all shareholders and the opportunistic behavior of family members for personal gains is restricted by their long-term investment horizon, concern for their reputation, and higher interest in the firm. Consequently, it appears more likely that family-owned organizations would be concerned with information transparency. This, in turn, should result in a positive relationship between family ownership and the extent of ICD. Conversely, the presence of Type II agency problems suggests that family owners may exacerbate this agency problem. Previous research on family businesses suggested that an increase in family ownership beyond a certain percentage could be detrimental for a firm, as the additional percentage of ownership leads to entrenchment and entrenched family owners tend to expropriate minority shareholders. Further, such concentrated ownership enables these family owners to dominate the firm and determine the strategies and policies for voluntary disclosures, including ICD. Caring less about information transparency may also result in less ICD. It is anticipated that this type of agency problem is very common in Bangladesh due to poor institutional and legal frameworks. Further, because the level of public interest in family-owned firms is expected to be relatively low, these types of firms are likely to experience less pressure from minority shareholders in relation to the voluntary provision of ICD. Accordingly, managers of family-owned firms might not invest heavily in ICD because the costs of investing in these activities may far outweigh the potential benefits.

It is posited that the combination of the effects of Type I and Type II agency problems will result in a non-linear relationship between family ownership and the extent of ICD. A quadratic specification of family ownership variable is used in this research. It is expected that any increase in family ownership (up to a certain percentage of ownership) will also result in an increase in the extent of voluntary ICD disclosure. It is also anticipated that at this ownership level, there will be less Type I problems, as any increase in share ownership is likely to align family interests with the interests of general shareholders. However, it is also predicted that beyond a certain percentage of ownership, any increase in family ownership will make the family members entrenched and Type II problems may arise. At this ownership level, a negative relationship between family ownership and the extent of voluntary ICD disclosure is expected. This above reasoning led to the following hypothesis:

H1. : There is a positive association between family ownership and the extent of ICD up to a certain level of ownership which is followed by a negative association between family ownership and the extent of ICD.

2.2. Foreign ownership

Previous studies have suggested that the percentage of foreign ownership influences the extent of voluntary disclosures (Al-Akra, Eddie, & Ali, 2010; Haniffa & Cooke, 2002). Due to language barriers, lack of local contextual knowledge, and the geographical separation between management and owners, foreign investors are likely to face a higher level of information asymmetry (Haniffa & Cooke, 2002). Thus, it is expected that foreign investors will demand more voluntary disclosures, including ICD. It is also expected that foreign investors in emerging markets, such as Bangladesh, will demand a higher extent of disclosures from companies, as these investors face more uncertainty and unfamiliarity than local investors (Al-Akra et al., 2010). Accordingly, it is likely that foreign investors will influence the corporate disclosure

[5] This mechanism provides both flexibility in the application of the “Corporate Governance Notification” and a means by which compliance will be assessed. Any noncompliance or non-application of a relevant rule could still be said to be consistent with the spirit of the notification. Non-compliances/non-applications are to be monitored by shareholders.

[6] Due to institutional pressures, mainly exerted by external aid agencies, Bangladesh has adopted the Anglo-Saxon model of corporate governance. The effectiveness of such corporate governance mechanisms in the context of developing countries has been questioned.

[7] Some countries have regulations for ICD; for example, Danish guidelines exist for intellectual capital measurement and reporting, there is also the European project for Measuring Intangibles to Understand and Improve Innovation Management (MERITUM) and the Australian guiding principles on extended performance measurement.