CHAPTER II

LITERATURE REVIEW

A. Theoretical Framework

This research examines how mechanism of corporate governance can effect intellectual capital disclosure. The theory that used in this research as follows:

1. Agency Theory

Agency theory is a theory that explains the relationship between the principal and the agent in order to make a decision (Jensen and Meckling, 1976). The agency theory also reveals that indeed between the principal and the agent has different interests. Principal has an interest to know the information and management activities related to the funds invested in a company. This information is also a form of corporate responsibility for management performance.

The agency theory is used as the basis of thinking to understand how corporate governance mechanism can affect intellectual capital disclosure level. Agency theory used to reduce conflicts of interest by conducting oversight mechanisms on corporate governance structures. The structure of corporate governance monitors the company to act in accordance with the interest of the principals; especially in disclosure of information which is one of them is intellectual capital information.

2. Signalling Theory

Signalling theory is a sign given by a company in order to give signal to stakeholders. The company will disclose information that attracts stakeholders' intention and gives positive signal for the company (Suwardjono, 2014). This theory appears because of asymmetry information between stakeholders and management, in which stakeholders did not receive the same information with management about financial and non-financial information.

Information is the important thing to inform the condition of the company in the past and future event. The company not only discloses the mandatory information, but also voluntary information. One of the examples of voluntary information is intellectual capital disclosure. Intellectual capital disclosure is information about the condition of human resource quality and company's strategies in order to develop the company. Thus, ICD information will reduce the level of asymmetry information and increase the firm value from stakeholders.

3. Resource Based Theory

Resource Based Theory (RBT) is a theory that is developed by theory in management strategic. RBT is the competitive advantage of the company. This theory assumes that company will achieve competitive advantage if it has something different that cannot be imitated by other competitor (Barney, 1991). The theoretical approach is related to the analysis of competitive advantage of a company that focuses on knowledge or intangible assets.

The main goal of a knowledge-based economy is to create value added (Pulic, 1998). The competitive advantage of a company can survive, if it is able to create value added and supported by resources that are not easily imitated by other competitors. A company will be able to compete if able to own, master, and utilize tangible and intangible assets including IC effectively and efficiently (Belkaoui, 2003). This strategy in merging tangible assets and intangible assets can increase the performance of the company. Based on this theoretical approach, a resource owned by the company will affect the performance of the company and will eventually increase the value of the company.

4. Intellectual Capital Disclosure

Disclosure is divided into two types, namely mandatory disclosure and voluntary disclosure. Mandatory disclosure is company's information that must be disclosed for stakeholder. On the other hand, voluntary disclosure is the disclosure of information related to the activities of the company which is disclosed voluntarily. Generally, voluntary disclosure is undertaken as one of the strategies used to attract stakeholder. Voluntary disclosure's item is not stated in the regulation, where company can choose the type of information to be disclosed.

ICD is part of voluntary disclosure. ICD provides information related to the intellectual capital of a company that consists of employee, customer, information technology, research and development and strategies used by the company. The concept of intellectual capital in Indonesia is based on PSAK number 19 (revision 2009) about intangible assets. Associated with agency theory, ICD is considered to reduce costs and control for agent. Meanwhile, the signalling theory, ICD can reduce information asymmetry. According to Bukh *et al.,* (2005), the purpose of ICD is to improve the effectiveness of the company's operations.

5. Corporate Governance Mechanism

According to the Organization for Economic Cooperation and Development (OECD) corporate governance is one of the key elements in improving economic efficiency and growth and enhancing investor confidence that involves a set of relationships between corporate management, councils, shareholders and other stakeholders as well as providing the structure through which Company goals, means of achieving those goals and monitoring performance (OECD, 2015).

The principles of corporate governance under the OECD are: (1) protection of shareholder rights, (2) equality of treatment of all shareholders, (3) the role of stakeholders related to the company, (4) openness and transparency, and (5) accountability of the board of commissioners. There are four corporate governance mechanisms used in this study that aims to influence ICD, namely CEO duality, board size, audit committee composition, and board gender.

a. CEO Duality

CEO duality refers to the situation when the Chief Executive (CEO) Officer also holds the position of the Chairman of the Board (COB) (Palanissamy, 2015). This dual role is a policy that makes one person in the company fills the position as a CEO and COB. However, CEO and COB have different roles. The roles of CEO are to develop strategies for recommendation to the board and make sure that the strategies are implemented in the business. On the other hand, the roles of COB are to ensure the effective operation of the Board, to support and advice the CEO in developing and implementing the strategy.

CEO and COB in the company should be separated because of their different roles. Agency theory emphasizes that a company should not be led by one person who plays a dual role as the CEO and COB in a company. The existence of CEO duality will create segregation of duty and lack of transparency because the person fills two positions and has enormous power within a company.

b. Board Size

Board size refers to the number of members on an organization's board of directors. The board size has a significant influence on the efficiency, effectiveness and supervision of management. Larger boards may be beneficial because they increase the pool of expertise and resources available to the organization. On the other hand, as the number of members on the board increases, this benefit may be offset by the incremental cost of poorer communication and increased decision making time that are often associated with large groups.

c. Audit Committee

An independent audit committee is a fundamental component of good corporate governance. Audit committees can be seen as internal control mechanisms that control agency issues between managers and investors. The audit committee is effective in overseeing corporate financial reporting and disclosure as well as curbing opportunistic management behaviors (Akhtaruddin and Haron, 2010).

In Indonesia, the audit committee is governed by Bapepam-LK Regulation No.IX.I.5 on the Establishment and Implementation Guidelines of the Audit Committee. The audit committee is a committee that made by commissioner to ensure that: (i) the financial statements are presented fairly in accordance with generally accepted accounting principles, (ii) the internal control structure of the company is well implemented, (iii) the implementation of the internal and external audits are conducted in accordance with applicable audit standards, and (iv) follow-up findings of audit results carried out by management (Kemenkeu and Bapepam-LK, 2010).

d. Board Gender

One of the issues of corporate governance mechanisms that have developed over the last few years is the issue of board diversity. Board diversity is a diversity that exists in the composition of the board of directors. The diversity of the board of directors can be based on various things such as ethnicity, skills, gender, and etc. As the developing of women's emancipation, the issues that evolve are board diversity based on gender.

Nowadays, the existence of women in the board of directors has increased significantly. It happens because the existence of women is considered to have a positive impact for the company. According to Kusumastuti *et al.,* (2007), women have a cautious attitude, tend to avoid risk, and tend to be more thorough than men. Therefore, with the existence of women in the board of directors, the decision is more precise and has a lower risk. In addition, according to Krishnan and Park (2005), women are considered to have cognitive feelings. Cognitive feelings in women are considered to have a positive effect on values and harmony within the organization that can encourage the disclosure of information and resources, provide more democratic leadership, and minimize conflict.

6. Global Industry Classification Standard (GICS)

Global Industry Classification Standard (GICS) is an industry taxonomy developed in 1999 by MSCI and Standard & Poor's (S&P) for use by the global financial community. MSCI Inc. (formerly Morgan Stanley Capital International and MSCI Barra), is an American provider of equity, fixed income, hedge fund stock market indexes, and equity portfolio analysis tools. The company is currently headquartered at 7 World Trade Center in Manhattan, New York City, U.S. While, Standard & Poor's Financial Services LLC (S&P) is an American financial services company. The head office is located on 55 Water Street in Lower Manhattan, New York City. Based on IC intensity, GICS classifies industry into 2: high-IC intensive industries and low-IC intensive industries.

High-IC intensive industries are companies that have large value added from intellectual assets (technology and knowledge) in order to increase competitive advantage. On the other hand, low-IC intensive industries are companies that still maximize their natural resources and apply traditional system. The company’s classification in GICS, as follow:

Table 2.1
Company's Classification in GIGS

High-IC Intensive Industries	Low-IC Intensive Industries
Automobile and Components	Commercial Services and Supplies
Banks	Consumer Durables and Apparels
Capital Goods	Consumer Services
Commercial Services and Supplies	Energy
Consumer Services	Food, Beverage and Tobacco
Diversified Financials	Food, Staples and Retailing
Health Care Equipment and Services	Materials
Insurance	Retail
Media	Transportation
Pharmautichal, Biotechnology, and Life Science	Utilities
Real estate	
Semi-Conductors	
Software and Services	
Technology, Hardware and Equipment	
Telecommunication Services	

Source**:** *Global Industry Classification Standard*

B. Literature Review and Hypotheses Development

1. The Influence of Board Size towards Intellectual Capital Disclosure

Board size has a significant influence on the efficiency, effectiveness and supervision of management (Hidalgo *et al,* 2011). The size of the board in a company has an impact on the company's performance. Based on resource dependence theory, it is emphasized that the larger size of the board will increase skills and offer a wide range of perspectives in making the decision. The larger board size also offers increased monitoring capacity for handling organizational activities. It was supported by Abeysekera (2010); Hidalgo *et al.*, (2010) in Kenya and Mexico.

The prior study of Hidalgo *et al.* (2011), found that when board size reaches 15, it has negative impacts on the level of intellectual capital disclosures. Cerboni and Parboneti (2007) and Arifah (2012) found that there is negative effect between board sizes towards ICD. Meanwhile, a study by Moeinfar *et al.*, (2013) shows that board size is positively related to intellectual capital disclosures.

The board's ability to control and encourage value added will be increase as the number of boards' increases. Therefore, higher board size makes conditions conducive to increased intellectual capital disclosure. As the number of board members increases, the variation in experience and expertise increases, so the need for information disclosure will increase. Based on the description above, hypotheses in this study can be formulated as follow:

$H_{1a:}$ Board size has positive significant effects towards intellectual capital disclosure level in Indonesia.

H_{1b}: Board size has positive significant effects towards intellectual capital disclosure level in Malaysia.

2. The Influence of CEO Duality towards Intellectual Capital Disclosure

CEO duality is a situation in which the Chairman of the Board at a company is also the Chief Executive Officer at the same time. The role of CEO and COB should be separated as an international corporate governance requirement. Agency theory suggests that a company should not be led by one person who plays a dual role as the CEO and COB (Palanissamy, 2015). The objective of the separation between CEO and COB is not only to reduce agency cost, but also to increase the transparency in the company. The separation between CEO and COB will reduce the opportunity to hide the information that should be disclosed.

According to Forker (1992), there is a negative relationship between voluntary disclosure and CEO duality. Taliyang (2011) have reported that there is no relationship between CEO Duality and ICD in Malaysia. Gul and Leung (2004) have reported that CEO duality is associated with lower levels of voluntary corporate disclosures in Hong Kong companies. Cerbioni and Parbonetti (2007) reported that concentration of power through CEO duality is negatively associated with IC disclosures. In contrast, using a sample of 192 U.S. firms, Boyd (1995) suggests that duality has a positive impact on corporate performance.

Based on the explanation above, the role of CEO and COB should be separated. A dominant personality in leading a firm may give disadvantageous to the interests of shareholders, and this phenomenon has been found to be associated with poor disclosure. Based on the description above, hypotheses in this study can be formulated as follow:

H_{2a}: CEO Duality has negative significant effects towards intellectual capital disclosure level in Indonesia.

H_{2b}: CEO Duality has negative significant effects towards intellectual capital disclosure level in Malaysia.

3. The Influence of Audit Committee towards Intellectual Capital Disclosure

Audit committee makes the interaction between board and internal auditor more effective. Audit committee makes sure that the company discloses the information based on the exist rules in order to reduce agency cost. Li *et al*., (2007) stated that the greater number of audit committee shows the wider of ICD.

Felo *et al*., (2003), Li *et al*., (2007) and Haji (2015) show that there is a positive relationship between audit committee and ICD. Meanwhile, Li *et al.,* (2012) shows that there is no relationship between audit committee and ICD.

Audit committee has a great responsibility in overseeing ICD. Audit committee plays as a control in corporate governance mechanism that has power to increase disclosures related to firm value. One of their responsibilities is to review the financial information that will be issued by the company such as financial reports, forecast, and other financial information. In addition, the audit committee is also authorized to access records or information about employees, funds, assets, and other resources related to the performance of their duties (Bapepam, 2012). Based on the description above, hypotheses in this study can be formulated as follow:

H_{3a}: Audit committee has positive significant effects towards intellectual capital disclosure level in Indonesia.

H_{3b}: Audit committee has positive significant effects towards intellectual capital disclosure level in Malaysia.

4. The Influence of Board Gender (the existence of women director) towards Intellectual Capital Disclosure

Gender diversity in board of directors generates more competence and expertise. Gender composition is considered important in enhancing the collective intelligence of the board of directors within the EU Corporate Governance Framework (EC, 2011). The existence of women director will increase the diversity of opinion, improve decision-making and leadership styles and provide excellence competitive by improving corporate image among stakeholder groups (Burgess and Tharenou, 2002; Carter et al, 2003). According to Krishnan and Park (2005), women are considered to have cognitive feelings. Cognitive feelings in women are considered to have a positive effect on values within the organization which encourages the disclosure of information and resources, democratic leadership, and minimize conflict.

A study conducted by Feijoo *et al.*, (2012) in Japan, Australia and the UK shows that the proportion of women directors had a positive effect on voluntary disclosure. Barako and Brown (2008) found that the representation of women on boards of Kenyan banks is positively associated with the extent of corporate social reporting information disclosed in annual reports. One of the board's roles is decide the level of voluntary disclosure including intellectual capital disclosure. In addition, the existences of women directors are considered can increase the level of disclosing the voluntary information. It is because the disclosure of voluntary information has positive impacts to improve the firm value of the company. Based on the description above, hypotheses in this study can be formulated as follow:

H_{4a}: Board gender has positive significant effects towards intellectual capital disclosure level in Indonesia.

H_{4b}: Board gender has positive significant effects towards intellectual capital disclosure level in Malaysia.

5. Intellectual Capital Disclosure in Indonesia and Malaysia

ICD is a voluntary disclosure that can be used by management to reduce information asymmetry. The territory of a country and its law system may be one of the factors explaining the level of voluntary disclosure. Web *et al.,* (2008), stated the relationship between globalization with voluntary disclosure that is attributed to the law system of company's country.

Companies that come from common law system get more pressure than companies from the civil law system in making good disclosures. Actually, globalization can provide benefits in increasing the level of disclosure for common law and civil law system. In this case, Indonesia uses civil law system, while Malaysia uses common law system.

Research on ICD by comparing two countries has been widely practiced. Ulum, *et al.*, (2016) examines and compares ICD levels of Indonesian and Malaysian universities. The result showed that there were no differences between universities in Indonesia and Malaysia in disclosing information about ICD.

The company from weak legal environment (civil law system) is less pressured to make good disclosure compared to the company from strong legal environment (common law system). Based on the description above, hypotheses in this study can be formulated as follow:

H_5 : There is a difference between Intellectual Capital Disclosures level in Indonesia and Malaysia.

6. Differences in the Influence of Board Size, CEO Duality, Audit Committee, and Board Gender (the Existence of Women Director) towards Intellectual Capital Disclosures level in Indonesia and Malaysia

Indonesia and Malaysia have different financial reporting regulations. The standard of financial statements in Indonesia uses the Standard Financial Accounting Standard (PSAK), while Malaysia uses Malaysian Accounting Standards Board (MASB). Although Indonesia and Malaysia have different standard, the enforcement in Indonesia is no better compared to enforcement in Malaysia and Singapore (Hary *et al.*, 2012)

In addition, Indonesia and Malaysia also have different corporate governance systems. As stipulated in Law No. 40 of 2007 on Limited

Liability Companies, Indonesia adopts two tier system. While Malaysia, based on existing practices, Malaysian companies are more likely to embrace a single tier system. This will affect the effect of independent variables on ICD considering that the variables of this study related to the financial statements and corporate governance. Based on the above description, it can be formulated hypothesis

H_6 : There are differences in the effect of board size, CEO duality, audit committee, and board gender towards intellectual capital disclosure level in Indonesia and Malaysia

C. Research Model

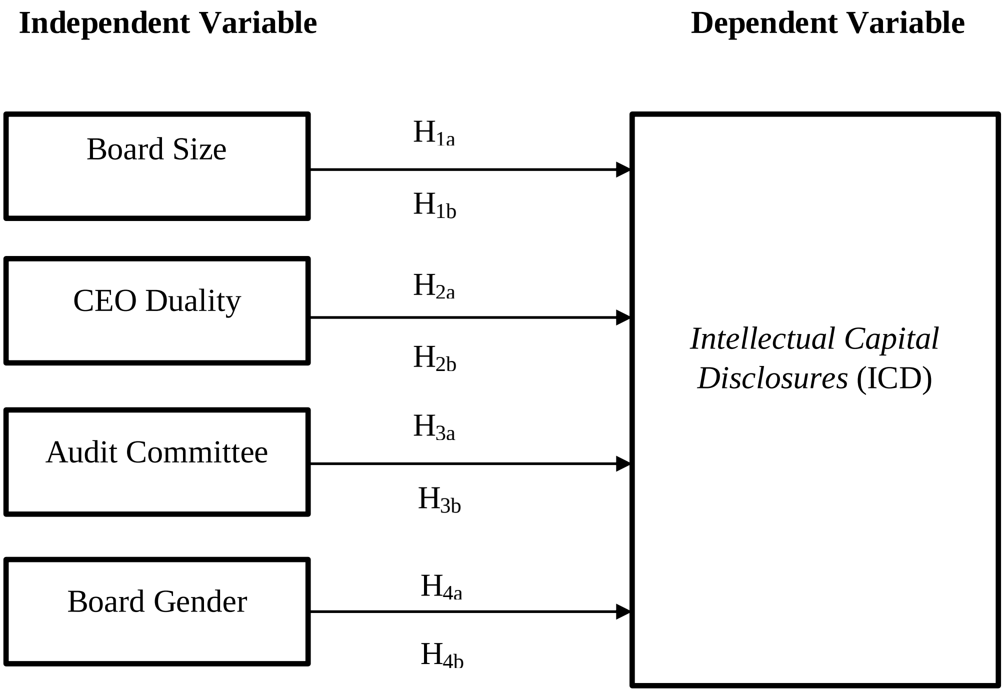

Figure 2.1
Research Model for Hypothesis 1-4

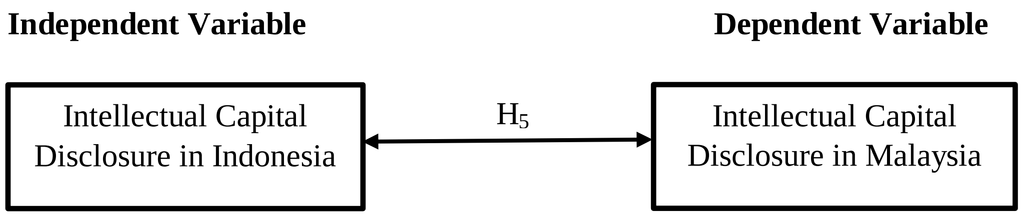

Figure 2.2
Research Model for Hypothesis 5

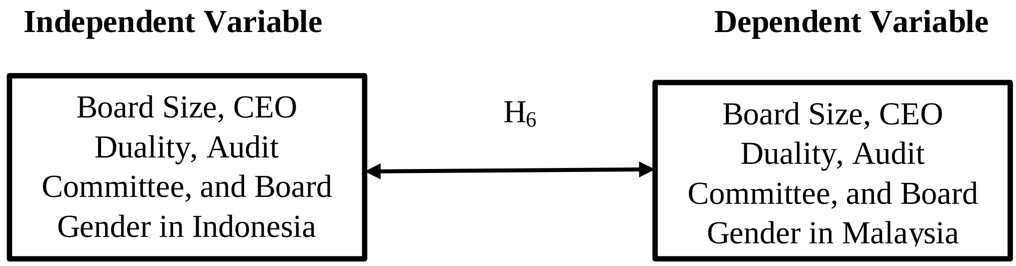

Figure 2.3
Research Model for Hypothesis 6