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Relationship in Principle between Corporate Governance, Intellectual Capital Disclosure and Firm Performance

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Abstract

This conceptual paper's goal is to discuss the relationship between business performance, intellectual capital disclosure, and corporate governance. This work proposes hypotheses about the relationship between corporate governance, intellectual capital disclosure, and business performance with the use of signaling theory. Their relationship's structure should inform all stakeholders about how corporate governance affects business performance. This demonstrates how well the governance is performing its duties to increase intellectual capital disclosure, which calls for essential adjustments to corporate procedures. It reveals the connection between the board nominating committee, the disclosure of intellectual capital, and corporate performance.

Keywords: Corporate Governance, Intellectual Capital Disclosure, Nomination Committee, Firm Performance.

1.0 Introduction

The new production system is built mostly on intellectual capital, which can be referred to as technology, knowledge, experience, and stakeholder relationships, to mention a few (IC). Intangible and intellectual resources are now acknowledged as significant resources in the modern economic system, also referred to as the knowledge economy. IC is a major source of revenue for businesses like software developers, finance, pharmaceuticals, hotels, and so on. In addition to their physical assets, manufacturers use integrated circuits to increase their competitive advantage (Abeysekera, 2010).

Businesses won't be able to sustain a competitive advantage if they fail to recognize, accurately assess, and disclose their intellectual capital, especially given the current economic climate. In order to survive the contemporary economic realities, which are knowledge-based, businesses must recognize and develop their intellectual talents, according to Ambassador Shuaibu Adamu Ahmed (2021), CEO of the Financial Reporting Council of Nigeria. Due to the present pandemic, businesses everywhere must now employ tough and scientifically based survival techniques.

Companies are aware that they cannot rely only on conventional and traditional business practices. As a result, they start implementing new ideas rigorously, creating new technology and software, and investigating intellectual capacities to conduct business in order to keep up with advancements in society and the business environment. To traverse the new standard of doing business, businesses in underdeveloped economies are still attempting to discover these efforts and intellectual capacities. As a result, the majority of these businesses have reduced operating and running costs, laid off employees, and closed several branches.

Investors assume underperformance when intellectual capital is not disclosed, which causes them to demand a higher rate of return (increasing the cost of capital) (Verrecchia, 1983). Additionally, businesses have recently realized how critical it is to manage external communication about intellectual capital strategically. Investors and analysts require information to demonstrate a significant discrepancy between the information contained in annual reports of a company and the information that is required by the market. In general, businesses, investors, and analysts need more trustworthy data on managerial abilities, experience, competence, and integrity, as well as customer interactions, human resource capabilities, and other aspects of intellectual capital. Investors and other stakeholders' perceptions of the openness and accountability will be impacted if this information is not made available to them.

In addition to this issue, the inability of firms to adequately value and disclose intellectual capital information in their financial reports will result in low and demoralize employees' performance. Employees, who contribute intellectual capital to the firm, will feel they are undervalued and not adequately rewarded because there is no full disclosure by firms with regards to the intellectual capabilities of employees and their contribution.

This will allow the employees to display non motivated attitude towards work and the progress of the firm, as it will show that their contributions are not adequately recognized and rewarded. Also, increase in employee fraud related issues will be recorded since one of the rationalizations for employees related cases is the absence of proper recognition and reward system for employee as noted by Steven et al (2014). All of this can directly affect the performance, and in the long run, the survival of the business.

Awareness of intellectual capital value has grown substantially in recent years. Over the last decade, there has been growing recognition that these types of assets have become the most valuable and fastest-growing part of our economy. Today, it is clear that intellectual assets and their effective management may be the only form of sustainable competitive advantage. As the burgeoning demand for knowledge-based products and services is changing the structure of the global economy, the role of intellectual capital in achieving a competitive advantage is becoming an important management issue in all sectors and disclosing intellectual capital information in the annual reports of firms will definitely increase its impact ion firms' survival and value.

Although, the role of corporate governance in disclosing information in the financial reports is important. However, identifying the corporate governance mechanisms, whose concept have direct relationship and impact on the disclosure of intellectual capital information, is one of the drivers of this study. Studies ion the effects of corporate governance mechanisms ion intellectual capital disclosure focus ion variables such as board size, board independence, and audit committee size in Malaysia (Abidin et al., 2009), and in Singapore (Kamardin et al., 2017), the United Kingdom (Healy, 2011) and ion different sectors of their economies.

In addition, to prior studies, the current study will look at the relationship between the characteristics of the board, in terms of Chief Executive Officer (CEO) duality, multiple directorships, induction and training of board, board experience and expertise with intellectual capital disclosure and firm performance. Also, the relationship between sub-committee characteristics like the nomination, and governance committee, audit committee, and remuneration committee and intellectual capital disclosure will be considered in this study.

Consequently, prior studies on corporate governance mechanisms and intellectual capital disclosure were conducted before the effect of Corona Virus (COVID), pandemic which has affected business activities world over and also made firms realized the need for knowledge assets in running the affairs of the business. Therefore, this study believes that since firms have realized the need for intellectual capabilities, their disclosure pattern with regards to IC will be different pre-pandemic and post-pandemic.

Despite the documented importance of IC on firm performance presented by Mutalib et al. (2018); Abeysekera (2001); Bontis (2005), there is contradiction on the detail of information disclosed in financial statement regarding IC as some firms disclose partial information while others disclose no information completely.

Moreover, identifying the appropriate corporate governance mechanisms that have relationship with the disclosure of IC information so that the policies of the firms show signal of capability and strength to the general public that can lead to the increase of firm performance has been a challenge. This study intends to fill this gap by considering the relationship between the above-mentioned corporate governance variables and intellectual capital disclosure. This is because, directors' responsibilities are first to its shareholders and the type of dominated shareholders that a firm have will significantly influence the nature of information to disclose.

2.0 Literature Review

Corporate Governance and Intellectual Capital Disclosure

Numerous studies have established the effect of various corporate governance mechanisms on the disclosure of intellectual capital. These studies have argued that corporate governance variables, such as board characteristics, explain the relationship between corporate governance mechanisms and intellectual capital disclosure. These studies, after conducting different studies in different economies around the world, found that there is a significant positive effect of board independence, board gender diversity, and board size on disclosure of intellectual capital. (Oren et al., 2020; Nicola et al., 2020). However, board characteristics cannot be considered the only factors influencing a company's decision to disclose intellectual capital information in its annual reports. Just as there are other vital elements in the management of the company that can also influence the disclosure of intellectual capital in the annual reports of the companies.

In addition to board features, Baldini and Liberatore (2016), Tajedo et al. (2016), Rodrigues and Craig (2017), and Muttakin et al. (2015) focused on ownership concentration, board composition, board and management structure. Their studies revealed a negative impact of these variables on the disclosure of intellectual capital by companies. They argued that the concentration of ownership and the composition of independent and non-independent directors will influence, in addition to other characteristics of the board, the disclosure of intellectual capital information by companies. They believed that having the majority of the company's shares controlled by a few would reduce the disclosure of intellectual capital, since the few shareholders who control the main shares of the company would prefer secrecy, especially regarding internal structures and knowledge of the company.

From the previous literature, it is evident that gaps have been created in the aspect of the variables, the studies mainly capture the characteristics of the board of directors, the audit committee and the ownership structure. However, while these variables are important corporate governance mechanisms that influence board decisions about whether to disclose intellectual capital information in company annual reports, there are other elements of the board that are equally critical in shaping the board's decision regarding the disclosure of intellectual capital information. This includes the board governance and nominating committee, remuneration committee and audit committee characteristics.

The board's nominating and governance committee is responsible for selecting and recommending appointments to the Board; it is also responsible for identifying the skills, knowledge and experience required within the board and employees. By these functions of the board of directors, as outlined in the new Nigerian Corporate Governance Code (2018), it means that the nominating committee plays a vital role in determining the intellectual capital of a company and can also shape the model disclosure of the company's intellectual capital. Additionally, the political affiliation of board members is likely to affect the disclosure pattern because when board members have affiliations with key politicians in the business environment, this can provide an advantage in business processes and procedures. For this reason, in addition to the variables explored above, this study will also focus on the board's nominating committee, remuneration committee and the audit committee.

Based on the above, the study t shows that the use of a scale can reveals the quality of the disclosure and reflect much more than the mere disclosure or non-disclosure of items. However, the study sample can be expanded to include both the knowledge sector and the traditional sector, and a comparative analysis can be performed. where a comparison can be made between traditional and knowledge-based sectors in an economy.

Furthermore, studies by Yan (2016), Smriti and Das (2020), Baldini and Liberatore (2016), and Nicola et al. (2020) focused mainly on the best companies. Generalizing results from large companies to small ones may not be ideal, as most of the decisions made by large companies may not be the same as those made by small companies. That is why this study focuses on all listed companies, including both small and large companies. The study also captures corporate governance variables such as audit committee financial expertise and intellectual capital disclosure meetings. It also proposes new measures to assess HC disclosure by looking at the quality of the information and not just the level of information disclosed.

Intellectual Capital Disclosure and Firm Performance

There have been discussions among academics about the effect of disclosing intellectual capital in annual reports and company performance. Some studies have found that there is a direct positive relationship where the company discloses more information about intellectual capital; its performance improves positively. Among the studies that go in this direction is the study by Saarce et al. (2020) that examined the disclosure of intellectual capital and corporate governance in non-discretionary earnings and market value (NDNI) of companies in ASEAN-5. Resource-based theory was used as the underlying theory. They used ordinary least squares and multiple linear regression as analytical tools using a sample of 112 technology companies listed in ASEAN-5 countries. They found that NDNI increases ICD and no component of ICD can affect treasury operations. The study also revealed that the ICD benefits from all of the performance indices used in the study. However, using a market-based performance measure, to link three corporate governance variables of board size, board gender, and board independence to determine the effect of ICD disclosure on business performance, may not present the reality of the relationship between ICD and business performance. Since market-based performance measurement can be influenced not necessarily by internal business activities, but by other external economic issues.

On the other hand, Tamer and Mohamed (2020) found a partial relationship between the ICD and business performance; they examined the mediating role of intellectual capital disclosure in corporate governance and the relationship of business performance. They used resource dependency theory as the underlying theory and used multiple linear regression on a sample of 150 companies listed on the Egyptian Stock Exchange. They found that the overall CG score has a significant positive impact on the ICD and on both measures of business performance. However, the ICD has only a partial mediating effect on the relationship between the overall corporate governance score and a company's operating efficiency index.

Another argument raised by Ute and Robert (2018), Albertini et al. (2020), Anifowose et al. (2017), is the effect of the ICD on the market value of the company and the value company money. The results of their study mainly confirm the expected positive effects of the voluntary ICD on monetary value for reporting firms that is, lower cost of capital, higher business value. In addition, CEOs highlight two new themes: environmental capital and digital capital, as major contributors to value creation. This study will be based on an improved study design regarding the theoretical basis and concept of value relevance, sufficient sample sizes, and alternative sources of intellectual capital disclosure.

The theoretical literature has suggested that IC has a positive impact on the performance of companies (Inkinen, 2015). For example, Gu and Lev (2011) argue that IC is an important driver of economic growth and business performance in most economic sectors. Clarke et al. (2011) argue that a company's value is often based in part on its IC assets; therefore, the efficiency of IC usage has a direct influence on performance. Lin et al. (2012) present similar arguments while Cuozo et al. (2017) point out that empirical research is needed as there is little evidence to support the theory (Wang & Chang, 2005), especially as current results are mixed. Some studies have shown that IC has a positive impact on company performance (see, for example, Chen et al., 2005; Tovstiga & Tulugurova 2007; Ting & Lean, 2009; Cheng et al, 2010; Clarke et al, 2011; Massaro et al, 2015; Andreeva & Garanina 2016; Martini et al, 2016), while others are inconclusive (see, for example, Huang & Liu, 2005; Kamath 2007, Ghosh & Mondal 2009; Maditinos et al., 2011; Dženopoljac et al., 2016). In addition, most of the literature has focused on mature market economies, with few studies on emerging markets and frontiers. Kamath (2007) argues that the consequences of IC are greater in these economies because they have abundant intellectual capital and ratios of intellectual capital 267 human capital at their disposal. Sukumaran et al. (2015) argue that, unlike developed market economies, frontier markets are smaller and less accessible and can be considered a subclass of emerging market economies. MSCI, a leading global index provider, currently contains 23 markets in its Frontier Markets Index, including Kuwait (MSCI, 2016). Therefore, this study addresses these gaps in the IC literature and examines the claim that ICD is a driver of business performance. Specifically, it empirically investigates the association between the extent of disclosure by listed ICs of non-financial companies in Nigeria and traditional measures of company performance (return on assets).

From the above literature, most studies have multiple regression and panel regression techniques used to find the effect of corporate governance on intellectual capital disclosure and company performance. However, only the study by Anifowose et al. (2017) uses the Generalized Momentum Method (GMM) to find the influence of CI disclosure on the market value of companies while this study will use GMM to discover the effects of corporate governance mechanisms on intellectual capital disclosure and how intellectual capital disclosure can affect business results through internal performance indicators.

Furthermore, most of these studies were done before the devastating effect of Covid on the business environment. The time difference between pre and post covid is likely to affect the valuation and disclosure of intellectual capital by companies. Indeed, the resulting effect of covid on the business world over has demonstrated the need for proper assessment and recognition of intellectual capital in order to survive and maintain competitive advantage. Corporate governance, according to Organization for Economic Co-operation and Development (OECD, 1999), is the way and manner at which organizations are being governed and ruled; it further views corporate governance as the system by which business corporations are directed and controlled. Controlling or governing organizations includes all the business operations and it also includes the organization's relationship with both internal and external stakeholders. A significant means for maintaining good relationship with stakeholders in addition to also creating value to the organization is through reporting or disclosure.

The corporate governance structure in place for any organization is majorly responsible among other responsibilities to report the business activities through financial reports. Items in the financial reports can be mandatory, that is, those items that are required by the law to be reported in the financial statements of firms and failing to disclose these items may result in sanctions from relevant authorities. On the other hand, there are those items that are voluntary and recommended; these items are not compulsory but are deem important. With regards to these important items, the corporate governance of a firm is solely responsible for reporting or not reporting them in the financial statement.

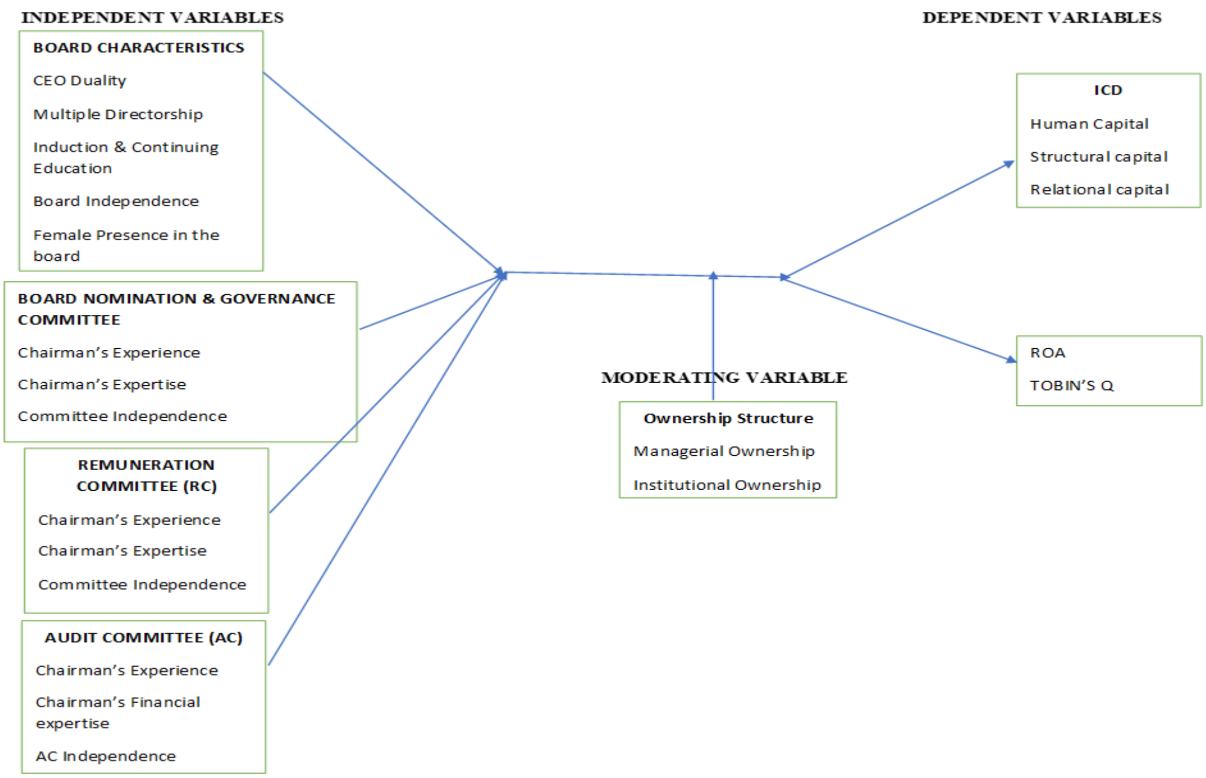

Figure 1: Relationship between Corporate Governance, Intellectual Capital Disclosure and Firm Performance

Intellectual capital disclosure falls within the jurisdiction of recommended items to be disclosed in the financial statement as such, corporate governance plays a significant role in an organization towards determining if information on intellectual capital will be disclosed or not, and if to be disclosed, what extent of disclosure should be provided. In view of the above, this study carefully selects corporate governance constructs that are significant to the decision of whether to disclose intellectual capital or not and to what extent should the disclosure be made. These constructs are the board characteristics, board nomination & governance committee characteristics, ownership structure and audit committee characteristics.

The nomination and governance committee characteristics considered are the chairman's experience and expertise committee independence and committee gender composition. These items are influencing factors with regard to the decision of disclosing intellectual capital information. The expectation is that firm with larger nomination and selection committee size will have more experience and diverse deliberations and views that will nominate and recommend for selection members and top management employees that can contribute to the intellectual capital of the firm, while the composition of independent non-executive directors on the nomination committee of the firm are expected that with their independent nature and vast experience, they will influence decision taken at the nomination committee.

Two major factors explain the presence of female directors on the nomination and selection committee towards influencing the decision to disclose intellectual capital. The first is that female directors employ a more trust-building leadership style than men, such that their commitment to "trust-building requires more information exchange and lower information asymmetry" (Srinidhi, 2011). The second is that female directors exhibit greater diligence in monitoring (Adams & Ferreira, 2009). In view of this, it is clear that board nomination and selection committee majorly performs an influencing role towards the disclosure of intellectual capital information by firms.

The functions that the remuneration committee performs, according to the Nigerian Code of Corporate Governance (2018), include, among others; development of a formal, clear and transparent framework for the company's remuneration policies and procedures and recommending to the board on the company's remuneration policy and structure for all directors and senior management employees. This committee is expected to motivate the directors and employees by ensuring that they are adequately remunerated, by doing so, the directors and employees will ensure that they appropriately use their skills, knowledge and expertise in ensuring that the firms succeed. This is to say that, firms with proper and adequate remuneration policy in place for their directors and staff, will want to disclose intellectual capital because there is a direct relationship between the remuneration policy of an organization and the intellectual capital contributed by its directors and employees.

Another corporate governance construct is the ownership structure which refers mainly to the composition of those who own shares of the organization. This is also expected to perform a moderating role of disclosing intellectual information in the financial reports of the organization. This is because the board of any firm has responsibility first to their shareholders before other stakeholders; as such, firms with managerial ownership are expected to positively influence the decision to disclose more intellectual capital information as this will be an avenue to communicate or signal other stakeholders of their managerial expertise in carrying out the activities of the firm. However, institutional ownership is expected to disclose less information about intellectual capital; this is because firms with either direct or indirect holding in other firms will prefer those activities of the firm be made less publicly. Therefore, ownership structure is expected to also perform moderating role towards the disclosure of intellectual capital information by listed firms in Nigeria.

Consequently, the audit committee is mainly responsible in ascertaining whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices; as such it oversees and endorses information to be reported by the organization in their financial statements. Where there are audit committee members with financial expertise, it is expected that with their financial knowledge, they are likely to endorse financial reports that disclose more intellectual capital of the firm.

Lastly, for each decision-making regarding information communicated to stakeholders, it is expected to have some effects on the overall performance of the organization. In view of this, the current study expects that when a firm discloses more intellectual capital information in its financial report, it is expected to have positive effect on the performance of the firm. This is because among the variable of intellectual capital is the human capital, referring to the employees of the firm. When information about the employee's activities, directors' initiatives and expertise are disclosed in the annual reports; this can motivate the employees and give them sense of belonging and job security. In return, they will continue to improve and give in their best which will directly result in increased performance of the firm. Also, disclosing intellectual capital information will give signal to external stakeholders, regarding the capabilities and operational efficiencies of the organization which can directly reduce the firm's cost of capital and directly affect the firm's performance.

3.0 Methodology

This conceptual paper is solely based on the review of literature of the link between corporate governance, intellectual capital disclosure and firm performance to confirm on the nature of their relationship. For the confirmation of the propositions, this paper shall proceed to use quantitative research design to identify the nature of relationship between corporate governance, intellectual capital disclosure and firm performance. The development and conclusions of this discursive paper as a conceptual one point out the possible application of a process-oriented epistemology of unity of knowledge to corporate governance. The underlying methodology of institutional discourse and integration with dynamic parameters is formalized.

4.0 Discussion and Conclusion

Basically, limited studies focus on the link between corporate governance, intellectual capital disclosure and firm performance, this indicate that firms have shown their commitment and move forward in sustaining their intellectual capital disclosure and firm performance even with the extant code of corporate governance implementation. These firms should be supported by the strong corporate governance.

However, there is a need for empirical evidence to strengthen this statement. This paper highlights on the requirement to determine the nature of relationship between corporate governance, intellectual capital disclosure and firm performance. The outcome shall witness on the involvement of those charge with governance for thriving to embed and intellectual capital disclosure in business reporting. Therefore, a strong board nomination and selection committee involvement is necessary during and after selection of board members. With the guide of signaling theory, this paper develops propositions for the relationship between corporate governance, intellectual capital disclosure and firm performance. Specifically, this paper emphasizes on the importance and involvement of corporate governance during implementation of any new policy that require changes or strengthening on the business processes. The governance involvement shall accord for increased intellectual capital disclosure, firm value and shareholders wealth maximization that ultimately contribute to economic development and nation building.

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