# Corporate Governance and Intellectual Capital Disclosure Practices in Sri Lankan Non-Financial Institutions

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## Abstract

This study examines the impact of corporate governance practices on intellectual capital disclosure in Sri Lankan non-financial institutions. Independent variables of the study comprise various forms of corporate governance attributes such as board size, CEO duality, audit committee size, and board independence. Intellectual capital disclosure is measured using a disclosure index which includes human, relational and structural intellectual capital disclosures. Data were collected from the annual reports of 45 non-financial institutions listed in the Colombo Stock Exchange from 2015 to 2019. Descriptive statistics, correlation analysis, and multiple regression analysis were performed to analyze the data. Out of four variables tested, only audit committee size and board independence had a significant impact on intellectual capital disclosure. Audit committee size had a significant positive impact on intellectual capital disclosure, while board independence had a significant negative impact on intellectual capital disclosure. It reveals that corporate governance practices improve disclosures of intellectual capital in Sri Lanka. It will resolve problems with information asymmetry among investors. The findings underscore the importance of creating appropriate policies and regulations relating to corporate governance.

***Keywords:*** *corporate governance, intellectual capital disclosure, human capital, structural capital, non-financial firms*

## 1. Introduction

Corporate governance is a framework of legal, institutional, and cultural factors that guide stakeholders' influence on managerial decision-making (Weimer and Pape, 1999). Today, corporate governance has become an inevitable discussion topic in developed and developing countries. However, the path in which corporate governance is organized differs among countries depending on the economic, political and social contexts. Disclosure of information can differ from firm to firm due to different factors. The board of directors manages information disclosure in annual reports. At present, the world economy is transiting from an industrial economy to a knowledge-based economy. As per this transition, to sustain the



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competitive advantage, the economy has to depend on the knowledge-based capital called the intellectual capital, such as knowledge workers, employee-related measurements, patents, trademarks, organizational system, and business strategies. One of the most recent and widely discussed issues in academic literature and the business press is how to design corporate governance mechanisms to improve firm transparency and solve the information asymmetry arising from the separation between ownership and control (Hidalgo et al., 2011). The Intellectual capital disclosure becomes crucial to signal investors about affairs of firms in an intense globally competitive environment (Abeysekera, 2008). Disclosure of intellectual capital in annual reports helps make capital markets more efficient by reducing information asymmetry between insiders and investors. This study seeks to identify corporate governance practices that are likely to reduce information asymmetry to increase the firm's value. Therefore, this study examines the impact of corporate governance practices on the intellectual capital disclosure of non-financial institutions in Sri Lanka.

## 2. Literature Review

There is very little evidence to show the impact of corporate governance practices on intellectual capital disclosure. To date, few studies such as Abeysekera (2008) and Pratheepkanth (2018) have analyzed the factors influencing the decision to disclose intellectual capital-related information in the annual reports of Sri Lankan firms. The literature regarding intellectual capital disclosure and its determinants is limited and inconclusive. The urgency of revealing and investor interest towards intellectual capital is not comparable with the existing practices in Sri Lanka. Although Abeysekera (2008) showed an increase in intellectual capital disclosure in several companies listed on the Colombo Stock Exchange (CSE), in general, the presented content-related intellectual capital is still low. Non-inclusion of corporate governance characteristics in the study could account for the inconsistent results since corporate disclosure policies emanate from the board. Another reason underlying the present study is to contribute empirically to the intellectual capital disclosure practices in Sri Lanka. Most of the studies on the relation between corporate governance on intellectual capital disclosure have focused on the financial sector.

Siti and Mariana (2011) found that only the frequency of audit committee meetings has a significant positive relation in influencing intellectual capital disclosure. They further report that 72.6 percent of the sample disclosed intellectual capital in their annual reports. However, the extent of the intellectual capital disclosure among Malaysian companies is still relatively low at about 3.45 percent. This result revealed that most Malaysian companies are aware of intellectual capital disclosure. However, they are not aware of how to measure, report, and disclose this information in their annual reports. This result is supported by Li et al. (2008) which shows that the level of intellectual capital disclosure and frequency of audit committee meetings are positively related to each other. However, the result did not support the other three hypotheses since the study found that intellectual capital disclosure is not significantly related to board composition, role duality, and audit committee size. Ho and Wong (2001), and Brammer and Pavelin (2006)also found no relation between board composition and intellectual capital disclosure.

Moreover, Li et al. (2008) conclude that the role duality was not found to influence intellectual capital disclosure. Akhtaruddin et al. (2009) found that audit committee size on the board is not related to voluntary disclosure. Li et al. (2008) examined the relation between intellectual capital disclosure and corporate governance variables, controlling for other firm' specific characteristics, for a sample of 100 UK listed firms. Intellectual capital disclosure is measured by a disclosure index score, supported by word count and percentage of word count metrics to assess the variety, volume, and focus of intellectual capital disclosure, respectively. The independent variables comprise various corporate governance structures: board composition, ownership structure, audit committee size and frequency of audit committee meetings, and CEO role duality. Their findings indicate that, in the absence of mandatory disclosure, effective corporate governance mechanisms positively impact the variety, volume (word count) and format (text, numbers, graphs/pictures) of intellectual capital disclosure. Results of the analysis based on the three measures of intellectual capital disclosure indicate significant association with all the governance factors except for role duality. Even though the results are mixed, previous literature illustrates the relation between corporate governance and intellectual capital disclosure (Siti and Mariana, 2011; Li et al., 2008; Hidalgo et al., 2011; Pratheepkanth, 2018). The contextual settings of emerging markets differed more from those of developed markets. The mixed outcomes in the extant literature and a dearth of emerging country studies suggest a significant gap in understanding corporate governance and intellectual capital disclosure. This study seeks to fill this gap by examining the impact of corporate governance practices on intellectual capital disclosure of non-financial listed firms in Sri Lanka.

## 3. Methods

This study adopts a quantitative approach to explain the impact of corporate governance practices on intellectual capital disclosure of non-financial firms in Sri Lanka. Board size (BS), CEO duality (CEOD), Audit committee size (ACS), and board independence (BI) are considered as independent variables. At the same time, intellectual capital disclosure (ICD) is used as the dependent variable, in which human capital, relational capital and structural capital are analyzed. Firm size (FS) and leverage (LEV) are used as control variables. The unit root test is employed to test the stationarity of the variables, and variance inflation factor (VIF) was used to detect multicollinearity among independent variables. Further, descriptive statistics, correlation and regression analysis are used to test hypotheses.

There are currently 282 companies listed in CSE under 20 business sectors. The target population of this study comprised 204 non-financial companies listed in CSE. The purposive sampling technique was used to select 45 non-financial firms as the sample. Secondary data obtained through annual reports for the period from 2015 to 2019 were used for analysis.

$$\mathrm{ICD} = \alpha + \beta_1 \mathrm{BS} + \beta_2 \mathrm{CEOD} + \beta_3 \mathrm{ACS} + \beta_4 \mathrm{BI} + \beta_5 \mathrm{FS} + \beta_6 \mathrm{LEV} + \varepsilon \text{ .............. (1)}$$

The regression model shown in equation (1) was used to find the impact of corporate governance on intellectual capital disclosure practices in Sri Lankan non-financial firms. In equation 1, intellectual capital disclosure is denoted by *ICD*. BS denotes Board size, *CEOD* denotes CEO duality, *ACS* denotes Audit committee size, and *BI* denotes board independence. Further, *FS* and *LEV* respectively denote Firm size and leverage. Finally, α, β and Ɛ denote constant, regression coefficients and the error term, respectively.

## 4. Findings and Discussion

As shown in Table 1, the maximum board size was 12, and the variation was low ($M$ = 8.44, $SD$ =1.95). Only 35 percent of selected firms have a duality of the firm's chief executive officer (CEO). Most of the firms have an audit committee consisting of three members ($M$ = 3.20). Only 40 percent of directors are independent in the board. The sample firms disclosed around 32 percent of intellectual capital items.

As shown in Table 2, there are no multicollinearity problems in the data as VIF value for all variables are less than 10. Ninety percent of changes in intellectual capital disclosure is explained by the changes in board size, CEO duality, audit committee size, board independence, firm size and leverage ($R^2$ = .902, $F$ = 32.07, $p < .05$). Results reveal that board size (β = 0.002, $p$ = .708), CEO duality (β = - 0.007 , $p$ = .239) and firm size (β = 0.002, $p$ = .441) do not influence on intellectual capital disclosures. However, audit committee size positively impacts on intellectual capital disclosure (β = 0.022, $p < .01$). Board independence has a negative impact on intellectual capital disclosure (β = -0.106 $p < .01$) and moreover, leverage positively impacts on intellectual capital disclosure (β = 0.089 , $p < .05$).

**Table 1: Descriptive Statistics**

| Variable | N | Min | Max | Mean | SD |
|---|---|---|---|---|---|
| Board Size | 225 | 5.00 | 12.00 | 8.44 | 1.95 |
| CEO Duality | 225 | 0.00 | 1.00 | 0.35 | 0.48 |
| Audit Committee Size | 225 | 2.00 | 5.00 | 3.20 | 0.75 |
| Board Independence | 225 | 0.13 | 0.66 | 0.40 | 0.11 |
| Firm Size | 225 | 8.63 | 12.45 | 10.05 | 0.66 |
| Leverage | 225 | 0.00 | 0.63 | 0.33 | 0.14 |
| Intellectual Capital Disclosure | 225 | 0.20 | 0.50 | 0.31 | 0.06 |

**Table 2: Multiple Regression Analysis**

| Variable | β | Std. Error | t-Statistic | Sig. | VIF |
|---|---|---|---|---|---|
| Constant | 0.216 | 0.062 | 3.461 | .001 | |
| Board Size | 0.002 | 0.006 | 0.375 | .708 | 1.054 |
| CEO Duality | -0.007 | 0.006 | -1.180 | .240 | 1.008 |
| Audit Committee Size | 0.022 | 0.005 | 4.664 | .000 | 1.126 |
| Board Independence | -0.106 | 0.039 | -2.720 | .007 | 1.027 |
| Firm Size | 0.002 | 0.003 | 0.772 | .441 | 1.074 |
| Leverage | 0.089 | 0.025 | 3.553 | .001 | 1.004 |

$R^2 = .902$; Adj. $R^2 = .874$; $F = 32.076$; $p < .001$

## 5. Conclusion

Findings indicate that corporate governance practices can help to increase the disclosure of intellectual capital, which in turn contribute to increasing firm value. This study indicates that corporate governance attributes are appropriate to explain the decision making of Sri Lankan non-financial firms regarding disclosure of information in the annual reports of the firms. Intense monitoring, proper mechanism, rules, regulations, and appropriate infrastructure help the firms to grow. The extent of intellectual capital disclosure among Sri Lankan companies is still relatively moderate at about 50 percent. This result revealed that most Sri Lankan companies are aware of intellectual capital disclosure. The findings of this study suggest that managers, policymakers, and other executives create appropriate strategies and regulations regarding corporate governance practices to attract more investors through reducing information asymmetry.

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