

The Relationship between Intellectual Capital and Corporate Governance: Evidence from the Malaysian Public Listed Companies

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Abstract

Intellectual capital is known as valuable organizational assets that move the performance and activities of a business. Intellectual capital includes four core component which are human capital, structural capital, relational capital and spiritual capital. Thus, with the existence of these assets, it is argued to have a significant effect on corporate governance practices in an organization. This paper has two aims, which are examining intellectual capital and corporate governance practices of Malaysian public listed companies and their relationship. Data were gathered via a self-administered questionnaire survey and analysed using descriptive and correlation analysis. Findings revealed that intellectual capital poses a significant positive relationship on corporate governance practices of Malaysian public listed companies. It can be concluded that this leads to a strong indication that acknowledging and managing intellectual capital to its optimum level is essential in an organization. Finally, recommendations for future research opportunities are put forward.

Keywords: Intellectual capital, Human capital, Corporate governance, Organizational values

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Introduction

Intellectual capital (IC) is regarded as valuable intangible asset in an organization which stimulates value creation and enhancement of overall competitiveness. According to Harrison and Sullivan (2006), a company's value is made up of both tangible and intangible assets. Additionally, Roos et al. (2005) emphasized the importance of IC by referring IC as all organizational's non-monetary and non-physical resources that creates value. Furthermore, when IC is properly acknowledged, managed and utilized, companies will able to withstand the adverse effect of economic pressures (Bontis et al., 2000; Tayles et al., 2007).

While IC is commonly categorized into three components: human capital, structural and relational capital (Mayo, 2000; Wall et al., 2004; Roos et al., 2005; Tayles et al., 2007; Marr, 2008), additionally spiritual capital is included in this study as one of IC components. As highlighted by Zohar and Marshall (2004) and Malloch (2010), companies with high spiritual capital which includes ethics, motivation commitment, moral and self-esteem are better at positioning themselves in achieving wealth, goals, sustainability and vision. Furthermore, it is rational to assume that when a company is managed and overseen by people who are highly competent, complying to rules and regulations and greatly spiritual, the company is presumably to have maintained good governance.

What is Intellectual Capital?

Literature on IC comes to conclude that IC is an intangible asset and exists in every organization (Kristandl and Bontis, 2007). IC comprises of valuable components that drives a company to achieve its

strategic objectives, improves operation efficiency while boosts the company's market value (Bontis et al., 2000; Jin et al., 2004; Marr, 2008). This study sets that IC comprises of four core components which are human capital, structural capital, relational capital and spiritual capital.

Human capital is commonly claimed as the most important component that shapes the future of an organization (Bontis and Fitzenz, 2002; Jin et al., 2004; Pedrini, 2007). Human capital includes competence, knowledge, skills, expertise, attitudes, technological know-how, creativity, leadership, education, innovativeness and changeability (Brooking, 1997; Roos et al., 2005; Tayles et al., 2007; Marr, 2008).

While, structural capital is associated with organizational pool of knowledge including databases, software systems, distribution networks, organizational charts, corporate culture, strategies and any other resources that carry higher value compared to its material value (Bontis et al., 2000; Tayles et al., 2007; Marr, 2008). Companies rely on structural capital to ensure the function of the company is conducted according to rules, policies, standards and procedures in order to achieve company's goal.

As for relational capital, it is described as the intangibles that progresses over time between a company and the entities external to the organization, for example marketing channels, customers and suppliers, customer loyalty, governmental and industrial networking, intermediaries, allied partners and lenders (Bontis et al., 2000; Roos et al., 2005; Tayles et al., 2007). At times, it can be challenging to retain relational capital, nonetheless, it can be geared towards building a better rapport and trust between a company and other parties.

Spiritual capital on the other hand, is described as the faith and emotion of individuals, whilst the organization carries vision, direction, guidance, principles, values and culture. Spiritual capital acts as a component that drives the accomplishment of human capital, structural capital and relational capital in an organization. Both individual and organization should act with integrity, honesty, justice, love, moral, ethic, motivation, self-esteem, commitment, determination, enthusiasm and team spirit (Zohar and Marshall, 2004; Ismail et al., 2005).

Hence, with the definitions of IC and its components, it can be concluded that IC is allied to all intangible assets or resources of an organization for instance knowledge, expertise, technology infrastructure, innovations and brand image that potentially drives an organization to conduct their business in a systematic and good manner (i.e: good governance practice) to eventually keep the business sustainable and achieve better performance.

The Synergy between Intellectual Capital and Corporate Governance

The importance of IC is adamant that without it a company is exposed to risk of inability to sustain profitability. In fact, international companies such as Microsoft, Netscape and 3M create value and profiting from their “brain power” which is IC (Sullivan, 1999). Nowadays, with the emerge of new social media platforms such as Facebook, Instagram, Tweeter which are used worldwide, are among the evidence of IC generation and utilization. This is consistent the resource-based view (RBV) theory which advocates that organizational resources, either tangible or intangible resources, must be identified, managed and utilized to achieve business goals thus achieve great performance (Wernerfelt, 1984; Wernerfelt, 1995). As highlighted by Andriessen (2001), IC synergies exist between intangibles that create uniqueness and wealth.

Generally, a company is established to generate profit. In order to generate profit and maximize shareholder’s wealth, the company will define their vision and work towards achieving it. Hence, the company needs to identify resources (tangible and intangible assets) and utilize them to create greater competitive advantage. Indeed, the importance of IC is apparent in uplifting a company’s value, thus improving performance, providing competitive edge, profitability, efficiency, improve business portfolio, strategic market positioning and continuous innovativeness (Sullivan, 1999; Bontis et al., 2000; Ismail et al., 2005; Roos et al., 2005; Tayles et al., 2007).

The importance of IC in Malaysia is declared in the Ninth Malaysian Plan and Tenth Malaysian Plan. In fact, the Malaysian 2012 budget with the theme “Transformational Nation” emphasizes on utilizing resources and development of human capital (Ninth Malaysia Plan 2006-2010, 2006; Tenth Malaysia Plan 2011-2015, 2010). This signifies that IC is vital in today’s business and economic sustainability.

When he world was shaken by the collapse of companies such as Enron and Worldcom in 2002, it was closely associated with failure of corporate governance. Good corporate governance is a cornerstone to sustaining current and future corporate success. Corporate governance refers to a way or manner in which a company is directed and controlled (Pickett, 2004; Gramling and Hermanson, 2006). According to Pickett (2004), it is about how a company carries out their business activities to achieve good performance. It is also how a company conducts its business operation in a proper and acceptable manner to pull higher confidence in the marketplace thus fulfilling society’s expectations on good corporate governance. Gramling and Hermanson (2006) stated that the boards of directors are responsible for the governance of their companies by setting the company’s strategic aims, monitor the management of the business, and reporting to the shareholders on their stewardship.

According to the Malaysian Institute of Corporate Governance (MICG), “Good corporate governance is the key to a robust and competitive corporate sector, which serves as a source for sustainable economic growth”. With the existence of MICG, it is apparent that corporate governance is also one of a central issue in Malaysia.

Additionally, Gramling et al. (2004) points out that effective corporate governance takes place when the management guarantees the procedures and activities of the organization are well administered thus providing a truthful and reliable management reporting (e.g. financial statements) and effective internal controls.

Further, O’Leary and Stewart (2007) emphasize that the role of corporate governance primarily rests on the Board of Directors with the support from the audit committee and executive management of a company who must ensure that the financial reporting is prepared at an utmost truthfulness, highly reliable and prepared in accordance with standards and regulation. Concurrently, they also need to ensure that there exists an effective risk management and internal control activities in the company. The importance of ensuring good corporate governance in an organisation is credential. This has also been highlighted in the Securities Commission requirements on corporate governance for Malaysian public listed companies. Moreover, Haji and Ghazali (2013) found that IC disclosures and corporate governance has strong relationship in Malaysian large companies.

Interestingly, an empirical study by Holland (2001) revealed that fund managers perceived that IC factors and corporate governance of financial institutions are correlated in putting a force to improve corporate performance. According to Gramling et al. (2004), quality corporate governance is reflected through achieving high corporate performance. Additionally, the role of intangibles in corporate governance has been addressed in Holland (2001) study on fund manager’s incentive to use intangibles as means to exercise corporate governance. Lack empirical evidence on IC and corporate governance, instilled the need for this study to take place. Hence, the research questions of this study proposed that IC is positively related to corporate governance. This relationship is as illustrated in Figure 1.

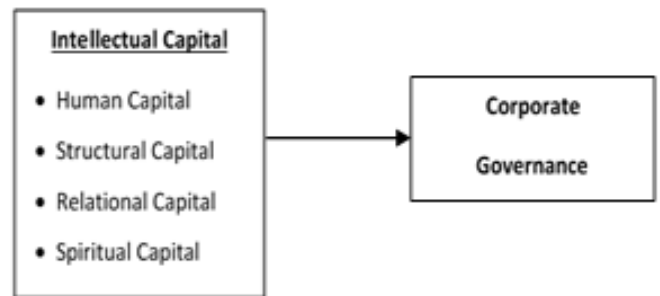


Figure 1. Conceptual Framework

Methodology

This study focused on identifying the relationship between IC corporate governance of Malaysian public listed companies (PLC). A quantitative research approach was adopted. The population which refers to the entire group of the intended investigation (Krejcie and Morgan, 1970; Sekaran, 2003) were all the public traded companies listed on the Malaysian Bourse stock market. Out of 857 companies in the total population (as at March 2010), the final sample number was 339 companies with in-house internal audit function, represented by the head of internal audit of these companies. They are selected as samples based on their capacity, extensive knowledge about the organisation’s activities and their exclusive authority to perform the duties of internal auditing with important functions within the management of Malaysian PLCs. Questionnaires (self-administered) were distributed to the head of internal audit which aimed to gather data on the topic area. Respondents were required to rate their opinions based on given statements using a 7-point Likert Scale ranging from 1 (strongly disagree) to 7 (strongly agree). Out of the total 339 set of questionnaires distributed, 144 cases were returned and used for analysis.

A reliability test using Cronbach’s Coefficient Alpha was employed to examine the reliability of data gathered as it provides a measure to confirm whether the instruments used are reliable, free from error and subject bias (Saunders et al., 2000; Salkind, 2006).



Generally, items tested generated satisfactory coefficient alpha value (α) of more than 0.70 which indicates that items in the questionnaire are reliable (Hair et al., 2003). A mean analysis using statistical package for the social science (SPSS) 16.0 were performed on items pertaining to IC components and corporate governance. Following that, Pearson correlation analysis was conducted to determine the strength of association and the direction of a linear relationship between two variables (interval data). Hair et al. (2003) and Pallant (2007) state that Pearson correlation analysis measures the linear relationship between two variables with correlation coefficient (r) ranges from -1.00 (negative relationship) to 1.00 (positive relationship).

Results

All respondents of the survey held the same position as others in the respective companies. They are either the Chief of Internal Audit, Manager of Internal Audit or Head of Internal Audit with all of them performing similar responsibilities in their company.

Mean Analysis

The results from mean analysis on items related to IC and corporate governance, is as shown in Table 1. Overall, all of the items on IC components (human capital, structural capital, relational capital and spiritual capital) have mean of 4.0 and above, which signifies that respondents agree on the importance and benefits of IC to the companies. The overall mean of each IC components are above 5.0. This indicates that respondents agree that companies do benefit from contributions relating to human capital and acknowledge the importance of knowledge sharing within the organisation. Respondents also well agree that companies recognize the significance of recruiting people who have the required knowledge, education and skills. As for structural capital, the companies recognize the importance of maintaining good operating system with fine written policies, procedures and operational instructions. The companies provide a conducive working environment for their employees who also support creativity and innovation. Concurrently, the management also encourages improvement in staff's educational and professional development.

In terms of relational capital, statistics revealed that respondents agree that the companies are efficient at attending to customer's wants; understand customer's profile and listens to their suggestions. Keeping good relationship with suppliers also seemed important to the companies and collaboration with other companies are aimed to gain competitive edge. Likewise, as for the spiritual capital items, generally respondents agree that employees in the companies are sincere, honest, motivated, committed, understand the work culture, ethical and have a mutual perception to achieve organizational goal. Respondents also agree that religious and philanthropic values do affect how individuals take their responsibilities. While, encouraging participation in community services activities could instill good values among employees.

Findings also revealed that there is a high good corporate governance practice among Malaysian PLCs. Respondents agree that their financial statement contains accurate information, reported in a timely manner and free from any intentional or unintentional error. The audit committees also performed their duties by closely monitoring IAF activities and communicate frequently with the internal audit function (IAF) in order to gather information or report from the IAF

Pearson Analysis

In order to assess the relationship between IC and corporate governance, Pearson correlation analysis was performed to answer the research propositions. Table 2 illustrates the result of analysis which shows that human capital ($r= 0.560^{**}$), structural capital ($r= 0.579^{**}$), relational capital ($r= 0.532^{**}$) and spiritual capital ($r= 0.553^{**}$) has a significant positive relationship with corporate governance. Generally, all IC components have a moderate strength of association with corporate governance. The result also indicates that level of IC is high in Malaysian PLCs which brings positive impact on corporate governance. Structural capital showed the strongest positive

relationship with corporate governance, followed by human capital, spiritual capital and finally relational capital. Interestingly, spiritual capital which was introduced as a new IC component included in this study, has also demonstrated its significant importance towards corporate governance.

Table 1: Mean Analysis Summary

Survey items	Mean
Human Capital	5.28
▪ Company benefits from work contributions	5.97
▪ Comprehensive recruitment plan	4.85
▪ Importance of 'knowledge sharing'	5.39
▪ Competency, knowledge and skills	5.12
▪ Employees are experts in their job	5.21
▪ Ability to develop ideas, knowledge and innovations	5.12
Structural Capital	5.37
▪ Policies, procedures and operational instructions	5.81
▪ Budget to establish good operation system	5.16
▪ Conducive corporate culture	5.33
▪ Good cooperation between departments	5.78
▪ Maintains accessible data system	5.3
▪ Effective systems and procedures	4.81
▪ Protects vital knowledge and information	5.01
▪ Encourages educational and professional development	5.36
▪ Departments synergize their strength	5.54
▪ Process and procedural improvements	5.58
Relational Capital	5.51
▪ Efficient in satisfying customer needs	5.42
▪ Listens and responds to customers	5.59
▪ Maintains good rapport with key suppliers	5.71
▪ Collaborates with other companies	5.30
▪ Discover stakeholder's expectation	5.49
▪ Optimistic of investors' confidence	5.55
▪ Clients and customers are loyal	5.47
▪ Understand customer's profile/ segments	5.52
Spiritual Capital	5.39
▪ Sincere, honest and truthful in work	5.48
▪ Motivated and committed in work	5.35
▪ Culture of trust, mutual respect and reciprocity	5.42
▪ Being ethical is the core value	5.46
▪ Religious and philanthropic values	5.00
▪ 'Common belief' on the need to achieve mission, goals and objectives	5.55
▪ Supportive and appreciative of employees	5.39
▪ Encourages community services	5.44
Corporate Governance	5.90
▪ Accuracy and quality of information reported in the financial statement	6.00
▪ Timeliness of financial reporting	6.06
▪ Voluntarily discloses the internal control activities in annual report	5.58
▪ Financial statement is reliable and free of intentional or unintentional error	5.94
▪ AC monitor closely the IAF activities to ensures IAF effectiveness	6.04
▪ Head of IA communicates with the AC and senior management	6.05
▪ AC holds frequent meetings with the Chief Audit Executive	5.75
▪ Adhere to rules and requirements	5.87
▪ High concern on the effectiveness of risk management and internal control activities	5.76
▪ AC emphasizes that the risk management and internal control activities are important	5.95



Table 2: Pearson Correlation Analysis Results

	HC	SC	RC	SPC	CG
HC	1	0.789**	0.650**	0.671**	0.560**
SC		1	0.720**	0.766**	0.579**
RC			1	0.747**	0.532**
SPC				1	0.553**

**Correlation is significant at the 0.01 level (2-tailed)

Note: HC= Human Capital, SC= Structural Capital, RC= Relational Capital, SPC= Spiritual Capital

Discussion and Conclusion

The fact that this study is the first of its kind conducted in Malaysia (after considering the lack of related literature) and turn it into added valuable contribution to the body of knowledge. Importantly, the findings prove that the relationship between IC and corporate governance does exist. Despite the fact that literature suggests that IC and corporate governance are closely related, there is lack of empirical study that looked into this. Hence, the results of this study has filled the research gap by taking a step further to investigate the association between these two variables. In other words, IC can influence a good corporate governance practice in which financial statements are reliable, internal control activities are monitored and good conduct of business are practiced.

High IC values for example knowledgeable or experienced employees, highly committed people, conducive work culture, good IT systems adopted, proper safekeeping and reviewed procedure manuals, maintaining good relationship with customers and stakeholders, high culture of trust, honesty, motivation and ethics actually do influence corporate governance practices. Thus, when all these values are in place, it eventually influences on how managers run the business. This supports the results from studies by Holland (2001), Holland (2003) and Ismail et al.(2005) which claimed that IC values such as knowledge, expertise and the reliability of information play vital role in influencing the effectiveness of corporate governance.

The misconception of IC and its prominent impact on business success may cost major loss to a company. Thus, IC must be properly identified, gathered and managed to drive organizational success. The success story of Malaysia owned companies such as Petronas and Proton involvement in the Formula One (F1) race which is marked as a major international event (Business Times, 2011) are among prominent examples. This has certainly spark a thought on how these companies expand over the years and are still standing strong as icon companies. Indeed, this shows how IC has evolved and expanded overtime since the establishment of the two companies. Similarly, the worldwide achievement of companies such as Microsoft, Apple and Facebook has obviously demonstrated the incredible worth of intangible asset and how it is turned into key value of a good conduct of a business. Hence, it is time that Malaysian PLCs should consider seriously understanding the IC concept and begin to instilling IC management in their organization.

Undeniably, the call for maintaining good corporate governance has also triggered a new evolution in the practice and activities of public listed companies. The Securities Commission that acts as the governing body of all these companies should consider embracing the importance of this vital function while keeping the awareness on the importance of IC in every organization. With regard to this, the Securities Commission or the Malaysian Institute of Corporate Governance (MICG) is in advantage to exploit the findings of this study for the betterment of Malaysian PLCs. Hence, these governing bodies could consider issuing guidelines on corporate governance with relation to exploring and monitoring IC values. In fact, Haji and Ghazali (2013) urges the need for the policymakers to enhance regulations on corporate governance in parallel with the need for companies to invest in IC.

On another note, this study is limited to perceptions of the internal auditors of Malaysian PLCs with an in-house internal audit function. Other companies with no in-house internal audit were totally excluded.

Therefore, future research can be extended to look into IC and corporate governance of all Malaysian PLCs. It is also interesting to further explore deeper into IC management and corporate governance practices via in-depth interviews with top managers of these companies.

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