CHAPTER II

LITERATURE REVIEW

A. Theoretical Framework

1. Agency Theory

Jensen and Meckling (1976) explain that agency theory is related to cooperation between two parties, namely the owner of the company (principal) and company management (agent). Managers are responsible for optimizing profits for the principal and agent will get compensation. Therefore, there are different interests. Agency conflict occurs when the principal is unable to ascertain whether the agent is doing it for their benefit. This can happen because the principal only has a little information about the condition of the company. In contrast to agents who act as parties involved in managing the company, they know more about internal information and prospects for the company in the future. This condition results in information asymmetry between the agent and the principal.

Jensen and Meckling (1976) divide costs into three types. The first type is the monitoring expenditure by the principal, i.e. it is the cost incurred by the principal to oversee the behavior of the agent. The second type is the bonding cost, i.e. it is the cost incurred by the principal to ensure that the agent takes action that should not harm the principal. The

last type is the residual loss, i.e. it is a decrease in the level of wealth of the principal and agent after the agency relationship.

One form of voluntary disclosure that can be done is intellectual capital disclosure. In this disclosure, the principal can better understand the actual condition of the company. In addition, company with high agency costs will be more stringent in monitoring their governance mechanism and provide more voluntary information in its attempt to reduce the cost Jensen and Meckling (1976) Fama and Jensen (1983). Corporate governance mechanisms can supervise companies so they can act according to the principal's wishes when making information on intellectual capital. Companies can suppress fraud so that transparency and accountability can be created.

2. Signalling Theory

Spence (1973) states that in a market there is always asymmetric information. Furthermore, Spence makes a signal criterion to be able to strengthen decision making. Signal theory shows that every organization will try to give a positive signal. Company will disclose information that attracts stakeholder intention and gives positive signal for the company (Suwardjono, 2014). Information asymmetry is a situation that occurs where there is a difference in information between stakeholders and management in terms of financial and non-financial companies. Based on this theory, it is very important for companies to provide information needed by stakeholders.

The purpose of this theory is to try to provide relevant information so that it can be used or utilized for recipients of information. Then, the recipient of the information makes adjustments in making decisions that are in accordance with the understanding received from the signal. Information that is done is important for the survival of the company, where the information can provide an overview of the conditions that occurred in the past, present, and in the future. This gives motivation to companies to disclose positive information to stakeholders and positive information is obtained by voluntary disclosure by the company.

The company discloses intellectual capital in financial statements in order to meet the information needed by investors and increases the value of the company. Positive signals from the organization are expected to get a positive response from the market. It can provide benefits to the company and provide a higher value for the company.

3. Stakeholders Theory

Chariri and Ghozali (2007) state that stakeholders are individuals, communities, and a group of people who in whole has power and even interests in the company. Stakeholders consist of shareholders, employees, customers, suppliers, creditors, the government and the community. Stakeholders are used as companies as a means of consideration to disclose or not to disclose information in the company's financial statements. (Sirojudin and Nazaruddin, 2011) state that in order to meet

the expected stakeholders, the company would voluntarily provide information on social, environmental, and intellectual capital disclosure.

According to this theory, management in the company will consider the interests of stakeholders in managing the company. This happens because management strives to do its best in its performance to achieve the success of its business and minimize loss that will be made by interested stakeholders in the company. Not only doing good performance, but conveying the result is also needed by stakeholder performance to make a broader disclosures. So, in addition to disclosures in financial statements, it is also necessary to make disclosures on intangible assets, namely intellectual capital.

4. Feminist Ethical Theory

Wicks *et al*., (1994) convey that feminist ethical theory emphasizes relationships (socialist) in carrying out a task. The presence of board gender will provide a better work atmosphere. The glass ceiling phenomenon is one of the reasons for the emergence of gender diversification issues (Zhang, 2012). This phenomenon says that there are obstacles for minority groups (women) to achieve top level management in an organizational structure even though based on their ability to meet the criteria. Credit Suisse Research Institute revealed that there were three factors in the presence of the debate, namely: (1) positive trends in the number of women in the governance structure of the entity; (2) government intervention to facilitate women in contributing to the

development of civilization; and (3) there is a change in perspective on gender debate, from the issue of gender equality to the issue of superior performance.

Many empirical studies have concluded that the presence of a woman is able to make a significant contribution to the company's performance. Board gender are said to be more participatory, more organized, more diligent, more critical, and can create a better working atmosphere (Huse and Solberg, 2006).Women carry out analysis more often so they can lead to better performance, which will encourage information disclosure in intellectual capital disclosure. The presence of board gender also indicates increasing diversity in the perspectives of board members so that it will influence corporate decision making (Rao *et al.*, 2012).

5. Intellectual Capital Disclosure

According to Bruggen *et al.*, (2009), the reason why the companies conduct intellectual capital disclosure is to minimize the level of information asymmetry so as to reduce the cost of capital. Intellectual capital disclosure can increase the value of relevance of financial statements. The increase in the value of the relevance of financial statements is as follows: (1) the result of failing to convey information relevantly is the deterioration of the company's financial position and can reduce the competitiveness of the company, (2) investors accurately assess the company's value for allocating resources using financial statements not

reporting intellectual capital, (3) managers are difficult to determine the relevance of intangible assets needed for company operations. Disclosure is divided into two types: 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 relating 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 regulation, where company can choose the type of information to be disclosed.

Intellectual capital disclosure can create trust with employees and stakeholders, and can prevent rumors and loss in the company. Bruggen *et al.*, (2009) state that trust is a long-term strategy that is important for the survival of the company in order to create higher stakeholder commitment. Information disclosure through intellectual capital can be used as a marketing tool. The company can provide evidence in the form of values that are applied and the ability to create wealth so that it can improve the company's reputation.

Intellectual capital disclosure in Indonesia is still voluntary because it has not been regulated in detail in the applicable accounting framework and accounting standards. Intellectual capital disclosure is included in additional information through published annual reports. To overcome the problems that exist in agency relationships such as information

asymmetry the solution is to do intellectual capital disclosure. Jensen and Meckling (1976) argue that agency costs arise from opportunistic managers, so they are motivated to voluntarily disclose information that is IC information to reduce agency costs.

6. Corporate Governance Mechanism

According to the Organization for Economic Cooperation and Development (OECD), corporate governance is one of the key elements in increasing efficiency and economic growth. In addition, corporate governance can also increase investor trust which involves a set of relationships between company management, boards, shareholders, and other stakeholders and it also provides structure through company goals, tools of achieving these objectives and monitoring performance.

In Indonesia, proxies from corporate governance include shareholders, commissioners, directors, audit committees, corporate secretaries, managers and other stakeholders. Of the several corporate governance items, it can be concluded that the structure of corporate governance is a part of the organ where there is a management function that maintains and runs the company. The corporate governance structure to be tested in this study is board independence, board size, board gender, audit committee and foreign ownership.

The effectiveness of corporate governance is determined by how corporate governance works within the company (Ashurov, 2010). No matter how good a corporate governance structure is, but if the mechanism

does not work properly, the final goal of protecting the interests of shareholders and stakeholders will never be achieved (Utami *et al*., 2012) . There are five corporate governance mechanisms used in this study: board independence, board size, board gender, audit committee, and foreign ownership.

a. Board Independence

The board independence is the total of independent director that exist in the company (Haniffa and Cooke, 2005). According to (Fama and Jensen, 1983) and Abeysekera (2008), if the board independence proxied by the proportion of independent directors increases, the control function will increase, thus making control over management more effective and reducing agency cost issued by the principal.

b. Board Size

Board size is the number of members that exist on the organization's board of directors. There are two main factors of the board size effect: (1) The problems of communication and coordination created by the size of the board and (2) the board’s ability to control management and the resulting agency problems stemming from the separation of management and control (Yermack, 1996). Too large board may actually have a lower ability to monitor and may increase the opportunity by the management to carry out the manipulations. Larger boards are likely to be less effective in monitoring top managers.

c. Board Gender (percentage of female director)

The board of directors is a group of people who have been appointed as the leader of a company. Women have a careful nature, are more careful than men, and are not in a hurry to make decisions. So, female directors are expected to be able to assist in making the right decisions so that they have a low risk.

d. Audit Committee

An audit committee is an effective corporate governance mechanism (Turley and Zaman, 2007). The audit committee is responsible to the board of commissioners in helping carry out the duties and functions of the Board of Commissioners. Based on the legal framework in Indonesia, public companies are required to have an audit committee.

In carrying out their duties and responsibilities, the audit committee acts independently. One of the tasks is to review the financial information that the company will issue to the public or the authorities, among others: financial statements, projections, and other reports related to financial information. According to internal governance mechanism, an effective audit committee should improve internal control and be powerful for improving the intellectual capital disclosure (Li *et al*., 2012).

e. Foreign Ownership

Foreign ownership in a companies can also be effective monitors for managers in emerging markets, because foreign ownership demands high corporate governance standards (Putri, 2011). However foreign ownership also raises the problem of information asymmetry more frequently (Aisyah, 2014). Information asymmetry occurs because of geographical and language barriers. It is also because of that the standard used in each country is different. To reduce this problem, companies with high foreign ownership will be encouraged to disclose their information more broadly and in detail, including information about intellectual capital.

7. Firm Value

Every company has the main goal of maximizing the value of the company. The function of financial management can be used to optimize company value. For investors, this value becomes an important concept because it is used as an indicator in assessing the company as a whole. Firm value is a very important thing because with a high corporate value, it will be followed by high shareholder prosperity.

The high value of the company becomes the desire of the owners of the company because the high value shows the prosperity of shareholders that is also high. The creation and increase of company value can be done by providing various information in the form of detailed and

comprehensive annual reports. The report provides information in the form of company resources and one of which is IC.

a. Profitability

According to Dewi and Sudiartha (2017), profitability is the company's ability to earn profits that can also be used as a tool to measure the level of effectiveness in a company. The aim is to see the development of the company in a certain time span, both decrease and increase, and to look for the causes of these changes. These measurements can be used as evaluation tools for management performance, whether or not they have worked effectively.

A company that has higher debt for its operational activities also get high profits. The high profit of this company is getting a positive signal from investors so that they are interested in investing in the company. This result in an increase in the level of high share demand followed by high stock prices. The high demand for shares increases the value of the company, so the higher the profitability, the higher the value of the company.

b. Firm Size

The size of the company is a scale that describes the size of the company that can be seen from the total assets, the number of sales, the average level of sales of the company and the average total assets of the company (Arindita and Sampurno, 2015). The indication used is the size of the sale. A company that has a high number of sales can

increase the turnover of funds generated by itself because these funds will be used for its operational activities. A large company is easier to access the capital market, so it has the ability to raise more funds for its operational activities. If the company lacks funds in running high operational activities because of high sales, the company can sell shares so that its operational activities continue.

A large company can influence investors. The bigger the company, the bigger its sales. If it has high sales, the level of profits obtained will be higher. So, the investors pay more attention to the company. If investors invest in a company with high sales levels, it has a good future. Thus, investors are interested in investing in the company. This can increase the value of the company reflected in the stock price so that the size of the company affects its value.

8. Global Industry Classification Standard (GICS)

Global Industry Classification Standard (GICS) is developed by Morgan Stanley Capital International (MSCI) and Standard and Poors' (S and P) that is used for financial global community. Based on IC intensity, GICS classifies industry into 2: high-IC intensive industries and low-IC intensive industries.

High IC intensive industries are industrial groups that are able to utilize their intellectual assets well so as to create a competitive advantage of the company and to improve company performance. The company

including the High-IC Intensive Industry has higher level of disclosure intellectual capital than Low-IC companies Intensive Industry.

Table 2.1
Companies Classification in GICS

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 Independence towards Intellectual Capital Disclosure

The board independence is the total of independent director that exist in the company (Haniffa and Cooke, 2005). Independent directors have an important role in monitoring and controlling opportunistic

behavior of the executive director (Jensen and Meckling, 1976). The mechanism of corporate governance can be strengthened by the presence of independent directors on the board.

According to Fama and Jensen (1983), argue that by monitoring and controlling the management, the board of directors can reduce agency conflicts between managers and owners. According to Hidalgo *et al.*, (2011), board independence has no effect on disclosure of intellectual capital. Cerbioni and Parbonetti (2007) obtain evidence that there is a positive relationship between independence and the extent of ICD. Recent study by Muttakin *et al.*, (2015) and Ishak and Ebel (2018) also finds that board independence is positively associated with the extent of ICD. It is because corporate governance mechanisms can be strengthened by the presence of independent boards. According to agency theory, board independence can reduce agency conflict by disclose more information.

Based on the above previous research, the existence of board independence is important. With board independence, intellectual capital disclosure is also increasing. Based on the description above, the hypotheses can be formulated as follows:

H_{1a}: Board independence has positive and significant effect towards intellectual capital disclosure in Indonesia.

H_{1b}: Board independence has positive and significant effect towards intellectual capital disclosure in Thailand.

2. The Influence of Board Size towards Intellectual Capital Disclosure

In a country or region, the size of the board size in a company has an impact on the performance produced. The first impact is that problems arise in terms of communication and coordination caused by the number of board of commissioners. Then, the second impact is the emergence of agency problems and the reduced ability of the board of commissioners to oversee management (Cerbioni and Parbonetti, 2007). This is different from the research conducted by (Sembiring, 2005) and (Abeysekera, 2008). Their results prove that a large size of the board size will have an impact on greater disclosure.

This happens because the larger the board size is, the more control is exercised on management. Based on agency theory, the high pressure provided by the board size will make management present as detailed information as possible, including ICD, especially the company's competitive strategy. Therefore, it can overcome the possibility of management fraud in reporting accountability and accountability related to the activities of the ICD that exist in the company and also expected to protect the interests of companies and stakeholders.

Research on board size towards ICD has been carried out by (Cerbioni and Parbonetti, 2007). It show that no influence between board size and ICD. Whereas, the research conducted by (Sembiring, 2005),

(Abeysekera, 2008), and (Baldini and Liberatore, 2016) find the results of a positive influence between the board and ICD. Based on the description above, the hypotheses can be formulated as follows:

H_{2a}: Board size has positive and significant effect towards intellectual capital disclosure in Indonesia.

H_{2b}: Board size has positive and significant effect towards intellectual capital disclosure in Thailand.

3. The Influence of Board Gender (percentage of female director) towards Intellectual Capital Disclosure

Women's presence on the board of directors can make changes to the board of directors. Their presence of women on the board of directors will provide a separate pattern for the composition of the board and provide more successful results than the composition of a homogeneous board of directors. Collaborative female leadership style will bring benefits because it can listen to innovations and complaints from employees, social support, and a win-win solution strategy.

On board of directors, women usually carry out analysis more often so that they can lead to better performance, which will encourage information disclosure in intellectual capital disclosure (Wahyuni and Rasmini, 2016). After reaching the point of success, female directors and commissioners will be careful in making decisions and will limit the disclosure of information that is important to suppress or prevent corporate

loss. Research conducted by Tejedo *et al.*, (2017) shows that female directors can influence intellectual capital.

In feminism theory, the presence of board gender will provide a better work atmosphere. Woman is able to make a significant contribution to the company's performance. Board gender are said to be more participatory, more organized, more diligent, more critical, and can create a better working atmosphere (Huse and Solberg 2006; Adams and Ferreira 2004). Based on the description above, the hypotheses can be formulated as follows:

H_{3a}: Board gender (percentage of female director) has positive and significant effect towards intellectual capital disclosure in Indonesia.

H_{3b}: Board gender (percentage of female director) has positive and significant effect towards intellectual capital disclosure in Thailand.

4. The Influence of Audit Committee towards Intellectual Capital Disclosure

The audit committee assists board independence in carrying out supervisory duties and reviews financial information issued by the company such as financial statements, projections, and other financial information. The audit committee serves as a management control tool to prevent fraudulent actions such as presenting inaccurate and relevant information and as a means of controlling corporate governance

mechanisms that have the power to increase disclosures related to company value. This is in accordance with stakeholder theory, related to the task of the audit committee that has responsibility to stakeholders to minimize the loss that will be borne by stakeholders. Managers will try to perform well, so that they can minimize loss and will also reveal wider intellectual capital for the interests of stakeholders.

The audit committee is authorized to access records or information about employees, funds, assets, and other resources related to the implementation of their duties. The audit committee in this case will have greater responsibility in overseeing the practice of intellectual capital disclosure. The audit committee will produce extensive and quality disclosure of intellectual capital information.

Li *et al*., (2012) find a positive relationship between audit committee and the extent of ICD. According to Felo *et al*., (2003), the positive influence of audit committees on intellectual capital disclosure can occur because the audit committee has a large responsibility in overseeing the practice of intellectual capital disclosure. Muttakin *et al*., (2015) study also finds a positive relationship between audit committee and ICD. Based on the description above, the hypotheses can be formulated as follows:

H_{4a}: Audit committee has positive and significant effect towards intellectual capital disclosure in Indonesia.

H_{4b}: Audit committee has positive and significant effect towards intellectual capital disclosure in Thailand.

5. The Influence of Foreign Ownership towards Intellectual Capital Disclosure

Foreign ownership in a company can also be effective monitor for managers in emerging markets because foreign ownership demands high corporate governance standards (Putri, 2011). Moreover, foreign ownership also raises more frequent information asymmetry problems (Aisyah, 2014). Information asymmetry occurs because of geographical and language barriers. The standard used in each country is different. To reduce this problem, a company with high foreign ownership will be encouraged to disclose its information. So, foreign ownership will make management present as detailed information as possible. Based on signaling theory, company will give positive signal to the stakeholder to invest their money in the company. That is why the company will disclose complete information related with intellectual capital disclosure.

Previous study finds that foreign ownership influences the ICD due to language barriers, lack of local contextual knowledge, and geographical aspect (Haniffa and Cooke, 2005). Foreign investors will require a higher disclosure from company. According to Utama and Khafid, (2015) finds that foreign ownership does not influence the ICD. On the other hand,

according to Aisyah, (2014) and Muttakin *et al*., (2015), there is a positive association between foreign ownership and ICD because foreign ownership will demand a higher extent of disclosures from a company. So, foreign ownership will influence the corporate disclosure practices, including ICD. Based on the description above, the hypotheses can be formulated as follows:

H_{5a}: Foreign ownership has positive and significant effect towards intellectual capital disclosure in Indonesia.

H_{5b}: Foreign ownership has positive and significant effect towards intellectual capital disclosure in Thailand.

6. The Influence of Intellectual Capital Disclosure towards Firm Value

Firm value can be created and improved by providing various information in the form of detailed and comprehensive annual reports. Reports can provide information in the form of company resources and one of which is intellectual capital. In connection with signaling theory, a company conducts intellectual capital disclosure in the hope that it can send signals of good news to external companies.

This shows that the company today is investing in intellectual capital which is expected to provide economic benefits for it in the future so that it ultimately increases its value of the company (Aida and Rahmawati, 2015). Research on ICD on firm value has been carried out by Orens *et al*., (2009), Jihene and Robert, (2013), and Aida and Rahmawati, (2015). The results of the study find that there is a positive influence of

ICD on firm value. Based on the description above, the hypothesis can be formulated as follows:

H_{6a} : Intellectual capital disclosure has positive and significant effect towards firm value in Indonesia.

H_{6b} : Intellectual capital disclosure has positive and significant effect towards firm value in Thailand.

C. Research Model

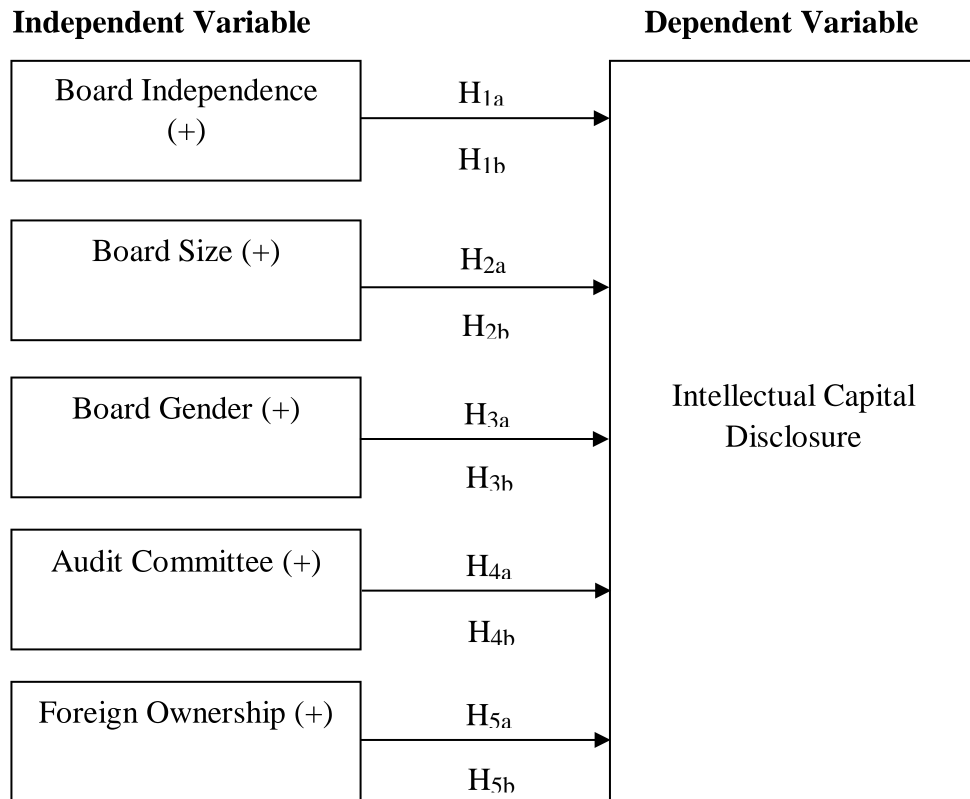

Figure 2.1
Research Model 1
The Influence of Corporate Governance Mechanism Towards ICD

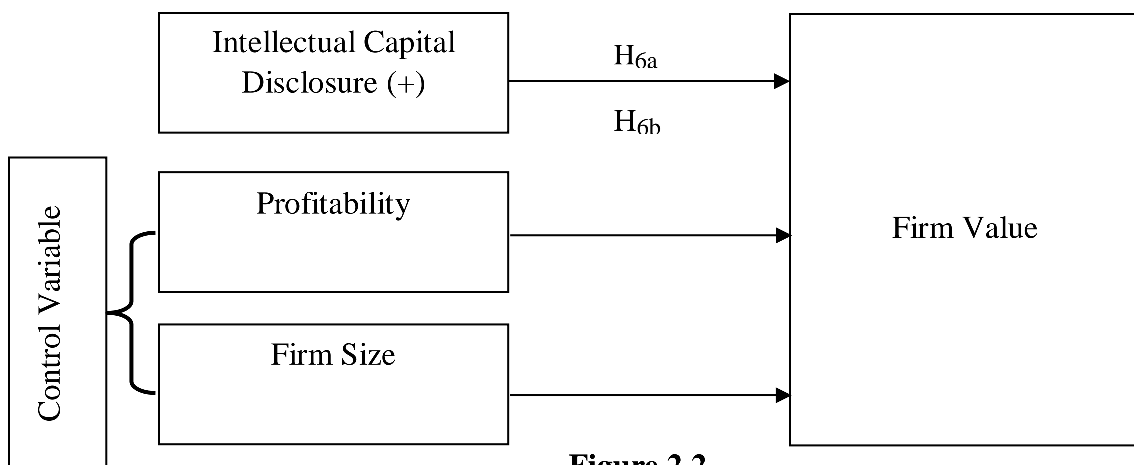

Figure 2.2
Research Model II
The Impact of ICD, Profitability, and Firm Size on Firm Value