The Moderating Role of Political Connections in the Relationship Between Board Characteristics and Intellectual Capital Disclosure

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ABSTRACT

In light of the modern knowledge-based economy, companies have become increasingly dependent on intellectual capital. Companies have increased their dependence on intangible assets and changed the structure of their traditional assets. The traditional accounting standards and financial statements failed to provide non-financial data to users such as stakeholders, investors and creditors. This has encouraged researchers in developed countries to focus on intellectual capital disclosure as the traditional financial statements and accounting standards do not address intellectual capital. Previous studies have adopted the descriptive approach in studying intellectual capital disclosure. Few studies have investigated the impact of board characteristics on intellectual capital disclosure in developing countries. In addition, these few studies have found mixed results about the relationship between board characteristics and intellectual capital disclosure. Politics play an important role, especially in developing countries; it affects the economic environment. Companies consider political connections an important external source that can be relied upon to reduce capital costs and effect voluntary disclosure. This study provides a new contribution to the literature as it departs from the mainstream of previous literature, which focuses mainly on the direct relationship between board characteristics and intellectual capital disclosure. Accordingly, the purpose of this study is to create the foundation for a theoretical framework based on Agency theory and Resource Dependence theory to the moderating effect of political connection on the relationship between board characteristics and intellectual capital disclosure in developing countries.

Keywords: *Corporate governance, Board characteristics, Political connections, Intellectual capital disclosure.*

1. INTRODUCTION

The global financial crises proved the failure of traditional accounting systems that mainly emphasized financial information but overlooked the non-financial and social information [1]. This has increased the interest of stakeholders in the level and quality of voluntary disclosure. In addition, traditional financial statements have failed to provide complete information on intellectual capital (IC) due to their indeterminate nature.

With regards to IC, numerous empirical research have investigated IC disclosure, e.g.[2; 3; 4; 5; 6; 7; 8; 9]. These studies revealed the interest in developed countries on intangible assets, especially IC. Few studies have investigated the impact of board characteristics (BCs) on IC disclosure. Nonetheless, the literature has offered mixed empirical evidence about this relationship. For example, Cerbioni and Parbonetti

[2] found that board size was negatively associated with the overall level of voluntary IC disclosure. On the other hand, Ahmed Haji [10] found a significant positive relationship between board size and IC disclosure. Unfortunately, the researchers did not focus on the variables that affect IC disclosure in developing countries. Consequently, the scarcity of previous studies in developing countries led to the failure to provide any clear evidence about the impact of BCs on IC disclosure in developing countries. However, these previous studies investigated the relationship between BCs and IC disclosure directly, without taking into account other variables that affect this relationship, such as political connections.

The purpose of this study is to examine the impact of BCs on IC disclosure in a developing country. It also intends to examine the impact of political connections on the relationship between BCs and IC disclosure. The research questions for this study are: Q1: What is the impact of the board characteristics on intellectual capital disclosure?

Q2: What is the moderating impact of political connections on the relationship between board characteristics and intellectual capital disclosure?

This paper includes four sections, the first is the introduction second is the literature review and framework, third is the hypotheses development, and finally, the conclusion.

2. LITERATURE REVIEW AND THEORETICAL FRAMEWORK

2.1 Literature Review

The current literature predominantly focuses on the importance of IC disclosure for example, [2; 10; 6; 7; 11;12; 4; 13; 14]. The vast majority of current literature classified IC into three categories: human capital, relational capital and structural Capital [14; 15; 6].

According, Ramadan et al. [16] human capital is the personal knowledge, skills, experience and capabilities of knowledge workers. Structural capital are all external relationships connecting the company with the

surrounding sources which includes, suppliers, development partners, customers, creditors and investors. Relational capital contains all types of the interrelationship with outside Parties or associates, such as customers, suppliers, competitors, industry associations, and other stakeholders, could impact the firm's business.

The researchers have linked between BCs mechanisms and IC disclosure. Most studies agreed that the BCs are important and affect IC disclosure [10; 6; 7; 11; 12; 14]. The BCs that were examined in these previous studies include board size, board independence and CEO duality. Drawing on Agency theory, Appuhami and Bhuyan [17] examined the relationship between corporate governance mechanisms and IC in Australia. They found a significant relationship between CEO duality and IC. However, the scholars could not prove the impact of board size on IC disclosure.

Moreover, Taliyang and Jusop [18] examined the association between corporate governance mechanisms and the extent of IC disclosure in Mexico. Hence, they found a significant positive association between board size and IC disclosure. Similarly, Falikhatun et al. [19] investigated the relationship between corporate governance mechanisms and IC disclosure in the annual reports of listed banks in Malaysia. They found no evidence supporting the impact of board size on IC disclosure. On the other hand, Anifowose et al. [20] opposed results even though the two studies were in Malaysia. They found a significant relationship between board size and IC disclosure of IPO companies in Malaysia.

Political connections (PCs) are widespread globally, especially in developing countries that do not have clear economic systems. Companies in developing countries strive to achieve their goals by creating solid political relationships [21]. Saleh et al. [24] defined political connections of a firm as a strong association between the organization's main shareholders, board directors or executive officers with the government officials. Maaloul et al. [22] discussed that officers and directors in any company needed the political power to effect on laws and regulations to reduce uncertainty. Shin et al.

[23] contended that political connections are important for firms since such connections enable access for the firms to resources for financing and operating activities. Vanini & Rieg, [25] argued that accounting regulations restrict mandatory disclosure of a firm's IC, leading companies to use voluntary disclosure to inform their stakeholders about their IC. This means that the IC

disclosure is part of the voluntary disclosure. In addition, they argued that voluntary IC disclosure is costly and may lead to a leak of knowledge. Companies are obliged to provide this type of disclosure to stakeholders despite the risks associated with disclosing intellectual capital. Similarly, Tessema, [26] argued that the Companies use a high level of voluntary disclosure to reduce the cost of capital. So that, IC disclosure is necessary to reduce the cost of capital or a better reputation, but it is costly and may lead to a leak of knowledge. Therefore, companies will be looking for alternative ways at a lower cost and not lead to a leak of knowledge. On the other hand, Political connections are a less expensive way to reduce the cost of capital by attracting investors [27]. The company can rely on political connections to avoid the risks and overcome any financing obstacles companies face.

Any quantitative research should rely on theory to explain the causal relationship between study variables.

Unfortunately, previous studies investigating the relationship between BCs and voluntary disclosure did not agree on a specific theory explaining this relationship. The most important theories that researchers used to explain the relationship between BCs and voluntary disclosure are Agency theory, Signalling theory, capital need theory, Stewardship Theory, Legitimacy theory, Stakeholder theory and Political cost theory [25; 26; 27; 28; 29; 30; 31]. On the other hand, despite the few studies that investigated the relationship between BCs and IC disclosure, researchers did not develop on a specific theoretical framework that explains this relationship and relied on a set of theories, for example, Agency theory, Legitimacy theory, Stakeholder theory and Resource Dependency theory [32; 33; 34; 19;

10; 13; 35; 6; 14]. Despite the many accounting theories, the agency theory is the most widely adopted by researchers that explain the relationship between the different parties in the corporate environment. It explained and analyzed the corporate governance mechanisms. Agency theory appeared in the early 1970s as an economic theory about the corporate environment. The firm was defined as a contract between owners and managers; this contract gives managers the power to manage the company's business. When Jensen first introduced agency theory and Meckling [36], maximize shareholder utility by determining contracts. The new economics was quickly applied to corporate governance to resolve the agency conflict by further disclosing the information that external users need. Under this assumption, Managers are required to provide all the owners' needs(information and disclosures) about the company's performance which allow them to monitor the performance and decisions of managers that represent the company's performance [1; 6].

Haji & Ghazali, [10] relied on Agency theory and Resource dependence theory to explain the effect of corporate governance mechanisms on IC disclosure. They explained the positive relation between board size on IC disclosure by resource dependence theory and used Agency theory to explain the negative relationship between director ownership. In addition, Gan [31] used Agency and Institutional theory to investigate the relationship between corporate governance mechanisms and IC disclosure in Malaysian companies' annual reports. Similarly, Falikhatun et al., [19] used Agency theory in their study to explain the impact of corporate governance mechanisms on IC disclosure. This discussion confirms that researchers have not yet agreed on a specific theoretical framework to explain the relationship between BCs and IC disclosure.

2.2 Theoretical Framework

Essentially, BCs encompasses several items and mechanisms with essentialities that vary across regions and nations following financial and legal contexts. This research would emphasise the BCs adopted within the particular study context based on the Jordanian commercial law. In line with the primary research problem (mixed empirical outcomes on the BCs impacts on IC disclosure), the researcher would focus on BCs that previously derived ambiguous outcomes on IC disclosure effects in past studies. Board characteristics in this study are the independent variable, which consists of three items: board size, board independence, and role duality. Agency theory is the leading theory that explains the impact of BCs on voluntary disclosure of all kinds through the assumption of agency conflicts that arises because of managers' ability to control much of the information and thus their ability to hide it and not provide it to stakeholders. Based on Agency theory and the assumption of agency conflict, in particular, managers disclose information that benefits them only. In contrast, stakeholders need accurate information that enables them to make appropriate decisions. As a result, based on Agency theory, BCs improve the level and quality of IC disclosure. For these reasons, the researcher relied on Agency theory to explain the effect of BCs on IC disclosure. In addition, Agency theory indicated that board size, board independence and role duality reduce agency conflicts between managers and stakeholders by disclosing intellectual capital.

Agency theory demonstrated the positive impact of BCs on IC disclosure in solving the problem of agency conflicts between managers and stakeholders by reducing the asymmetry of information. Although companies realize the importance of voluntary IC disclosure, they consider that voluntary IC disclosure is costly and may lead to a leak of information about the capabilities and resources of the company. Therefore, companies are trying to find an alternative to voluntary IC disclosure to be less expensive and dangerous. In developing countries, politics and politicians influence the economy directly and indirectly. So that companies are trying to take advantage of political relations and politicians to achieve their interests. Previous studies in chapter two of this study proved the effect of political connections on the level of asymmetry of information, and political connections contribute to reducing capital costs.

Theoretically, Resource dependence theory explains that companies are constantly searching for external sources to help them achieve their goals, such as increasing profits and reducing costs. Consequently, Resource dependence theory can be relied upon to explain the role of political connections as an external source of strength that companies depend on to reduce capital costs and the risks of exposing information associated with voluntary IC disclosure.

3. HYPOTHESES DEVELOPMENT

3.1. Board size

Corporate governance mechanisms did not identify the number of board directors. The previous studies did not provide a clear direction for the impact of the board size on IC disclosure. Theoretically, Agency theory explained the positive role of the board size in reducing conflicts of interests between managers and stakeholders through voluntary disclosure. This study relied on the Agency theory to explain the positive impact of the board size on the level and quality of voluntary IC disclosure. So the researcher is hypothesized that the board size has a positive impact on IC disclosure.

H1: there is a significant positive effect for the board size on the IC disclosure.

3.2. Board independence

Based on Agency theory, independent members support transparency and compliance, thereby reducing conflict of interest between managers and owners. Independent members are interested in voluntary disclosure because they consider it to be an essential transparency tool. Consequently, this study relied on Agency theory to explain the positive effect of the board independence on IC disclosure. Hence, the researcher supposed this hypothesis.

H2: there is a significant appositive effect for the board independence on the IC disclosure.

3.3. Role Duality

Agency theory suggests the necessity of separating the executive director and the chairman of the board of directors to get rid of the agency conflict and encourage transparency in providing information. The separation between CEO and Chairman enhances the level and quality of voluntary disclosure. Consequently, this study relied on Agency theory to explain the negative effect of the role duality on IC disclosure. Hence, the researcher supposed this hypothesis.

H3: there is a significant negative effect for the role duality on IC disclosure

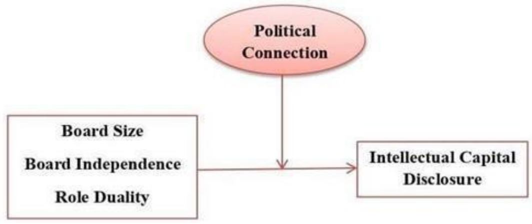

Fig. 1. *Conceptual Model*

3.4. Political connections

Political connections can be considered as a substitute for voluntary IC disclosure. Companies rely on political connections in order to reduce the cost of capital, attract investors, and strengthen the corporate relationship with surrounding societies. Political connections are considered one of the most important external sources that support the company's capabilities in achieving its goals by reducing capital costs. Consequently, this study relied on Resource dependence theory to explain the negative effect of political connections on the relationship between BCs and IC disclosure. Hence, the researcher supposed thishypothesis.

H4: There is a negative significant moderating effect for political connections on the relationship between BCs mechanisms and IC disclosure.

4. DISCUSSION

This study investigated the effect of board characteristics on intellectual capital disclosure. By reviewing previous studies, the literature presented different results about the impact of board characteristics on IC disclosure. Also, previous research was unable to provide a clear theoretical framework about this relationship.

Theoretically, the agency theory provided a clear explanation about the positive impact of board characteristics on IC disclosure, which reduces the level of conflict of interest that may occur between managers and stakeholders. For example, an increase in the size of the board means that there will be experts in companies who will provide higher levels of IC disclosure, thus reducing conflicts of interest.

Despite the clarity of the theoretical side through the agency theory in explaining the effect of board characteristics on IC disclosure, the previous empirical studies in developing countries found different and mixed results that prompted the researcher to consider studying the moderating effect of political connections (PCs) on this relationship.

The literature provided clear evidence that PCs have a fundamental impact on the performance of companies, the cost of capital, and voluntary disclosure. Companies consider PCs an important external source that they can rely on as an alternative to voluntary disclosure. These companies believe that voluntary disclosure is costly and exposes the company's sources and strengths to competitors.

This study believes that companies in developing countries rely on PCs to bypass corporate governance controls to achieve their goals at the lowest possible cost. The politically connected companies also depend on PCs as an alternative to the voluntary disclosure imposed by corporate governance mechanisms.

Due to the low level and quality of IC disclosure in Jordan despite applying an effective governance system, this study investigates the moderating effect of political relations on the relationship between board characteristics and voluntary IC disclosure. The researcher believes that this study will provide essential contributions to the impact of PCs in developing countries on board characteristics and IC disclosure. The researcher noted the focus of recent studies in the Arab countries on the negative effect of PCs on the Arab economic environment. Therefore, this study is the first study to investigate the impact of PCs on the relationship between board characteristics and IC disclosure. This study will present Important results for researchers, governments, and competent authorities.

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