CHAPTER 3

INTELLECTUAL CAPITAL DISCLOSURE – MOTIVATIONS AND DETERMINANTS

3.0 INTRODUCTION

Corporate disclosure is summarised in Haniffa (1999) as the responsibility of a firm's board of directors through different communication channels primarily to communicate corporate performance and demonstrate accountability to potential information users for the purposes of aiding, influencing or changing their decision making. Deegan (2002) supports the argument and contends that information is necessary to change perceptions and influence decisions. Restoring and maintaining investor trust and confidence is one of the primary motivators of disclosure. Intellectual capital (IC) disclosure can then be seen as a way to improve the market's understanding and confidence in a firm's value creation process and the economic risks it faces and thus reduce uncertainty. This then 1) helps build trust with stakeholders (Beattie and Thomson, 2005), 2) provides an opportunity to employ a valuable marketing tool (Van der Meer-Kooistra and Zijlstra, 2001), and 3) promotes a higher and more stable share price (e.g. Gibbins et al., 1990; Holland, 1997).

With various IC reporting frameworks having been developed and corporate annual reports available as the medium for communication (Beattie and Thomson, 2007), the decision of whether or not to disclose such information is down to the firm's management. The first objective of this chapter is to review the theoretical underpinnings of external IC reporting as well as the motivations and perceived disadvantages. The second objective is to review potential factors that influence IC disclosure practice. Important in-depth studies have shed light on the process of corporate disclosure and the market for information (e.g. Gibbins et al., 1990; Holland, 2004, 2006a; Graham et al., 2005). The theoretical framework of corporate disclosure process developed by Gibbins et al. (1990) suggests that disclosure output is a function of external and internal stimuli and of a firm's predisposition and existing response structures (internal and external). To understand better the influential factors, in the context of this thesis, the chapter addresses two internal factors, namely corporate governance and company characteristics, and selects external (market) factors that potentially influence corporate disclosure in general and IC disclosure in particular, providing a framework of determinants of IC disclosure. Although previous studies have examined the association between voluntary disclosure and corporate governance mechanisms, company characteristics and capital market factors in annual reports (e.g. Adrem, 1999; Chen and Jaggi, 2000; Haniffa and Cooke, 2002; Eng and Mak, 2003), few studies have specifically addressed the associations in terms of IC disclosure.

This chapter, together with Chapter 2, builds the foundation of the motivation for this study. It sets out the framework for the development of corporate governance, company characteristics and market factors hypotheses in Chapters 6, 8 and 9.

3.1 MOTIVATIONS FOR IC DISCLOSURE - THEORETICAL UNDERPINNINGS

As summarised by Beattie and Thomson (2007), voluntary disclosure of IC information can be explained in terms of theories, although the development of a theoretical framework underlying such disclosure is still in its infancy (Abeysekera, 2006). These include arguments based on information asymmetry (e.g. Amir and Lev, 1996), agency (e.g. Cerbioni and Parbonetti, 2007; Patelli and Prencipe, 2007), signalling (e.g. García-Meca and Martínez, 2005), resource-based (e.g. Tayles et al., 2007), and positive accounting, legitimacy and stakeholders (e.g. Deegan and Gordon, 1996; Brown and Deegan, 1998; Deegan, 2000, 2002; Beattie and Thomson, 2007) theories.

However, the proposed theories seem 'fuzzy' in the sense that all of them are logical and acceptable but none could be voted as the best theory of IC disclosure. This is because the proposed theories complement each other and are dependent on the focus in the study. Therefore, it is suggested in Haniffa (1999: 27) that theories of disclosure are best reviewed as 'a shift in paradigm' and none of the disclosure theories that spring from the different paradigms are superior as they are all merely competing, if not complementing each other, resulting from the shift in emphasis of accounting.[1] The 'shift in paradigm' in terms of disclosure theories has been discussed in Haniffa (1999) in the order of 'pure economic theory', 'political-economic theory', 'socio-economic theory' and 'cost-benefit' of disclosure.

The following discussions provide some theoretical perspectives on IC disclosure, very much in line with the 'shift in paradigm' argument made in Haniffa (1999), with perceived benefits and costs of disclosure.

3.1.1 PURE ECONOMIC THEORY

Pure economic theory has a primary focus on the needs of shareholders and managers, which is mainly based on the objectives of fulfilling the desire for profit making and loss avoidance (e.g. Cooper and Sherer, 1984). Therefore, the theory is concerned with meeting the shareholders' need for information to reduce uncertainty which might affect their wealth and the management's goal of shareholder wealth maximisation.

Bedford (1973) suggested that shareholders as owners of the company have a 'right to know' everything they desire about the company, based on the stewardship argument. Viewing from this perspective, disclosure of information on value-creating and

[1] Paradigms may rise and fall and it is argued in Haniffa (1999) to be quite common for one paradigm to be seen as winning over another, although it does not mean that the winning paradigm is better than its competitors. It is also argued by the author that the disclosure process needs to change constantly because the values, norms, beliefs and attitudes of individuals in society are forever changing and there is no consistency in what will be demanded from companies by society from one period of time to the next. The author identified some of the shifts in the emphasis of disclosure over time that before the late 1960s, disclosure is merely to fulfil the stewardship function with emphasis on shareholders and creditors; by the late 1960s, it shifted to an informative perspective which emphasises that financial reports help to reduce information asymmetry resulting from divorce between ownership and control; and in the 1970s, disclosure is seen as a tool that recognises the concepts of accountability and responsibility of firms to other stakeholders. Such shifts gave rise to different disclosure theories, with some being competing while others complementing.

competitive advantage-building assets of firms, i.e. IC, implies that businesses operate for the benefit of shareholders. However, the theory fails to recognise the existence of other stakeholders in society who may also have an interest in or are exposed to the risk of the company's business activities. In addition, the theory fails to recognise other goals pursued by managers in reality apart from profit maximisation (Haniffa, 1999).

In addition, the demand for finance and the existence of capital markets where finance raising can be facilitated exert pressure on companies to expand information availability to a wider audience. Healy and Palepu (2001) argue that information and incentive problems, i.e. information asymmetry and agency problems impede the efficient allocation of resources in a capital market economy. Disclosure and the institutions created to facilitate credible disclosure between managers and investors play an important role in mitigating these problems. Therefore, information asymmetry and agency theory, derived from economic theory will be reviewed in this section. It is then followed by a review on signalling theory and decision usefulness.

3.1.1.1 AGENCY THEORY AND INFORMATION ASYMMETRY

Two of the key theoretical explanations of corporate voluntary disclosure lie in the concepts of information asymmetry and principal-agency contracting. Agency theory has been a dominant theory of many disclosure studies (e.g. Chow and Wong-Boren, 1987; Cooke, 1989a, b, 1991, 1993; Hossain, et al., 1994). It defines the role and the relationship between the 'principals' (i.e. shareholders and creditors, who are providers of finance to a firm) and the 'agents' (i.e. managers) (Jensen and Meckling, 1976), i.e. managers are employed to act as agents on behalf of the shareholders in managing a firm, which builds an agency relationship. This relationship causes concern that the agents who make important decisions do not bear a substantial share of the effects (e.g. the firm's wealth) of their decisions (Fama and Jensen, 1983a, b). The conflicts of interest that exist between principals and agents give rise to agency costs.

Principal-agency contracting is the means to realign their interests (Jensen and Meckling, 1976; Fama and Jensen, 1983a, b; Berle and Means, 1932). However, such contracts are insufficient to eliminate all agency conflicts. First, the contract is incomplete and therefore, assigns significant residual control rights (discretion) to management, who, as a result, have considerable latitude for self-interested behaviour. This includes the spending of corporate resources on perquisites, such as company cars, lavishly furnished offices and taking higher-than-market salaries for themselves (Jensen and Meckling, 1976). A second reason is that contracts are often based on accounting numbers (Watts and Zimmerman, 1986), thereby creating additional incentives for management to expedite the recognition of economic gains and delay the recognition of economic losses, as well as to choose aggressive accounting methods that increase their earnings-based compensation (Holthausen et al., 1995) or help to avoid debt-covenant violations (Dhaliwal, 1980; DeFond and Jiambalvo, 1994; Sweeney, 1994). These perverse effects persist even when contracts are not directly structured around accounting figures. It has been evidenced that incentives to 'beat' the contract and manipulate the accounts also exist when compensation is structured in terms of market information, or through stock option plans (Bergstresser and Philippon, 2006; Goldman and Slezak, 2006).

One additional drawback of contracts is that they are costly. As argued by Watts (1977), designing and implementing contracts and covenants introduces costs that relate to 1) monitoring, the principal will incur expenditures to control the agent's behaviour – the agent will also incur expenses to guarantee that s/he will not take certain actions to harm the interests of the principal or that s/he will compensate the principal if s/he does so (bonding costs); 2) negotiation and renegotiation of the contract; 3) loss of opportunities due to fixing some choices in the contract; and finally 4) even considering monitoring and bonding, the actions of the agent will still probably differ from the actions the principal would have taken. The wealth effect of the divergence is what Jensen and

Meckling (1976) refer to as the 'residual loss'.[2] All these agency costs of monitoring, bonding and the residual loss are borne in the agency model.

Besides the effort (shirking) and perquisite problems described by Jensen and Meckling (1976), a further problem is associated with managers having a different horizon from that of shareholders. This is because while firms have an indefinite life, and thus its shareholders are concerned with an indefinite stream of cash-flow, the managers' horizon is usually limited to the cash-flow received during their employment. This can lead managers to have a short-term perspective on investment, with a preference for projects with quicker cash-flow returns that are not necessarily value-maximising (Farinha, 1999).

Fama and Jensen (1983b) argue that the control of agency problems is an important factor in the survival of organisational forms. The separation of 'ownership' from 'control' implies a loss of effective control by shareholders over managerial decisions and results in information asymmetry between managers and investors (Berle and Means, 1932). This problem is exacerbated by the increasing number of shareholders in current business corporations where direct management by the shareholders becomes problematic. Bushman and Smith (2001) argue that accounting reports provide a way of direct and indirect input to the corporate control mechanism, where an open and active communication strategy increases the transparency to capital markets.

In addition, agency theory argues that management compete with one another for investors' funds and have incentives to provide financial information to the investment community (Watts, 1977). The importance of stock markets as a source of finance for firms is becoming ever more important. Managers who want to issue public debt or equity have an incentive to increase the value of the firm to outsiders by making more voluntary disclosure, and thus reducing information asymmetry risk and cost of capital

[2] Refer to Fama and Jensen (1983b) for a detailed discussion on residual claims and agency problems.

(Jensen and Meckling, 1976; Lang and Lundholm, 1993). Failure to provide adequate information would make it very expensive, if not impossible, to raise funds from public capital markets. The more information provided by a company initially, and the more stringent its commitment to providing continuing disclosure, the less costly it is for investors to monitor management and, hence, the more favourable the other terms and conditions of the financing (Stulz, 1999).

With regard to information asymmetry, Akerlof's (1970) paper is often cited as the starting point in any analysis of information which is not evenly distributed. The author suggested several applications for his theory, which has also served as a basis for further theories, including signalling theory. One type of information asymmetry exists between providers and users of information, i.e. between owners and managers of public companies (Healy and Palepu, 1993). Williamson (1984) argues that the specificity of transactions can create information asymmetries that can be mitigated by disclosure,[3] which provides greater transparency and enables investors to better anticipate future transactions for valuation purposes. Holland (2006a) contends that many firms have been heavily exposed to radical knowledge-intensive changes in corporate economic processes, which have had a major impact on firms' disclosure agendas. Financial reports have been found to be incapable of fully reflecting the corporate value creating processes and activities, which exacerbates information asymmetries between firms and the suppliers of equity and debt capital and other information users about the information on investments and returns of IC (e.g. Rylander et al., 2000; Barth et al., 2001; Holland, 2001, 2003). This is evidenced by the growing gap between market and book values (see Section 2.2.1 in Chapter 2). Information asymmetry arises when

[3] It is supported by the literature that improved corporate disclosures result in lower information asymmetry (e.g. Welker, 1995; Healy et al., 1999; Leuz and Verrechia, 2000; Diamond and Verrecchia, 1991; Kim and Verrecchia, 1994; Coller and Yohn, 1997; Botosan, 1997; Lundholm and Myers, 2002), and thereby reduce cost of capital of firms (Botosan, 1997) and allow better prediction of future earnings by investors (Lundholm and Myers, 2002). In addition, firms with high growth prospects will have specific knowledge (e.g. about technology, corporate strategy, and human resources) that is not effectively and efficiently transferable to investors through traditional accounting disclosures. Frankel et al. (1999) posit that firms attempt to mitigate the information asymmetry of high-growth-prospect firms by making disclosures through additional means.

markets do not perfectly aggregate private information, and can lead to higher transaction costs, lower liquidation, and ultimately, mispricing of a firm's shares. The increase in information asymmetry has also increased opportunities for moral hazard, adverse selection and other opportunistic behaviour by management (Aboody and Lev, 2000). The growing information asymmetry also impedes efficient allocation of resources (Edvinsson and Malone, 1997;[4] Cañibano et al., 2000), which in the end produces social costs such as unemployment, reduced productivity, and even diminished national competitiveness (Andriessen, 2004). The point, supported by Lev and Zarowin (1999), is that reporting inadequacies may adversely affect investors' and firms' welfare, and Meritum (2002) that they may result in significant economic losses both for firms and their suppliers of goods, services or capital.

To resolve the problem of increasing IC information asymmetry, shareholders will demand more stringent disclosure. Managers should therefore be willing to disclose IC information in order to enhance the firm's value by providing investors with a better assessment of the financial and IC position of the firm and help reduce the volatility of stock returns (Edvinsson and Malone, 1997; Stewart, 1997; Guthrie et al., 2007).

The content of the published accounting reports is assumed to have potential importance for the motivation and control of managers (Grinyer et al., 1994). Information asymmetry places the 'principal' in an unfavourable position regarding the choice and monitoring of the 'agent' (Jensen and Meckling, 1976). Therefore, the two theories, i.e. information asymmetry and agency theory complement each other.

3.1.1.2 SIGNALLING THEORY

Signalling theory also holds some attractiveness for explaining IC disclosure. Various authors (e.g. Cooper and Sherer, 1984; Roos and Roos, 1997) posit that the most

[4] '… too many deserving companies are underoptimized and undercapitalized … troubled firms are artificially propped up until they collapse, pulling down shareholders and investors with them' (Edvinsson and Malone, 1997: 8).

compelling reason for IC reporting is to render the invisible visible. In addition, De Pablos (2002) defines IC disclosure as serving to make the organisational intangible resources visible, where the components of IC are an indication of a firm’s future value and its ability to generate positive financial results. Sharing and signalling the management’s understanding of the firm’s value drivers to the stakeholders is indeed a strong, if not the strongest, motivator for IC disclosure (Gray et al., 2004). The theory posits that an organisation attempts to signal positive information to investors through the annual reporting mechanism on the ground that management generally recognises the potential economic benefits for the firm deriving from an effectively managed disclosure policy (Williams, 2001).

It is argued that managers use corporate reporting to signal and celebrate corporate achievements in order to present favourable images of the corporation (e.g. Gray and Roberts, 1989; Gibbins et al., 1990; Patten, 1992; Brown and Deegan, 1998; Neu et al., 1998). By signalling the firm’s IC investment and management activities, investors and other stakeholders may be able to assess better the firm’s value and future wealth creation capabilities, allowing a more precise valuation of the firm and a decreased perceived level of risk (Benston, 1976; Edvinsson and Malone, 1997), consequently leading to lower cost of capital (Botosan, 1997; Lev, 2001; Vergauwen and Van Alem, 2005).

The theory builds on the concept of information asymmetry and is also an element of agency theory. Spence (1973) posits that signalling theory focuses on the process used by decision makers in situations of information asymmetry between two parties that one party can send signals which provide indications of its quality to the other party. The theory is similar to agency theory in that it recognises the separation of ownership and control in modern corporations and that market pressures on management will motivate management to disclose information material to investors (Ross, 1979). However, one of the assumptions of this theory which makes it slightly different from agency theory is that there are signalling costs that are inversely related to the quality of information (Morris, 1987). Signalling theory can be considered to be based on the need to resolve information asymmetry problems. Morris (1987) tried to indicate that the signalling motives are greater when the quality of the product is high.[5] Furthermore, Ross (1979) argued that firms with no information or bad news also have incentives to signal just like those with good news in order to distinguish their firms from others. In the case of no information, there is a tendency for managers to signal 'no news' by stressing on the stability of earnings, etc. In the case of bad news, Skinner (1994) argued that managers of these firms also have a legal incentive to disclose the bad news as they might incur reputational costs if they fail to do so in a timely manner. Ross (1979) further asserts that for firms which have previously made a disclosure, a failure to do so subsequently will be regarded by the market as a signal that the unpublished data are adverse, thus logically creating a powerful incentive to disclose.

Overall, the theories discussed above are mutually consistent, explaining IC disclosure in terms of a cost-benefit trade-off (Beattie and Thomson, 2007).

3.1.1.3 DECISION USEFULNESS

Apart from the above mentioned theoretical basis for IC disclosure studies, Miller and Whiting (2005) also included decision usefulness as a motivator of IC information disclosure.

As an information system, the justification for accounting can be found only in how well it serves those who use it. The Preliminary Views on the conceptual framework for financial reporting published by FASB (2006) opts for a decision-useful objective, and

[5] Verrecchia (1983) demonstrated that managers with superior information on the demand for its product will disclose more to convince both competitor and the capital market of the quality of its product, thereby increasing the value of the firm's stocks. Similarly, when the demand is low, the firm would also like to convince the point to its competitors, thus reducing the competitors' output and thereby increase the informed firm's profit (Gigler, 1994).

states it as follows:

The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions. (OB2)

The objective of financial reporting…encompasses providing information useful in assessing management's stewardship. (OB28)

The objective therefore highlights usefulness in making resource allocation decisions (Lennard, 2007). Therefore, the underlying purpose of accounting is to provide decision-useful information about the economic entity to those who need such information. However, conventional financial reports, failing to reflect a wide range of value-creating intangible assets, have become of limited relevance to investors (Johnson and Kaplan, 1987; Francis and Schipper, 1999; Lev and Zarowin, 1999; FASB, 2001; Kohlbeck and Warfield, 2007). Therefore, there is an incentive for management of IC-intensive companies to disclose value-relevant information to assist investors in better valuing the company's share. Thus, IC disclosure enhances the decision usefulness objective of financial reporting, which will assist the investing community for more rational decision making processes.

3.1.2 POLITICAL-ECONOMIC AND SOCIO-ECONOMIC THEORIES

Political-economic and socio-economic theories are closely related. The shift from a purely economic to a political-economic paradigm was due to the limitations in the pure economic theory which emphasises the needs of shareholders and managers and the belief that concentration on those needs is sufficient for an understanding of the role of accounting report in society (Cooper and Sherer, 1984). Cooper and Sherer (1984) posit that any form of accounting contains a representation of a specific social and political context and argue that accounting research should be more focused on creating accountings that are more valuable to society. Similarly, Morgan and Willmott (1993) call for accounting research that seeks to render visible and amplifies accounting's wider social and historical constitution and significance as a technology of social and organisational control.

Tinker and Neimark (1987: 72) defined political-economic theory as the ways used by 'social protagonists' of accounting information and corporate reporting to mediate, suppress, mystify and transform social conflict and the effects on the distribution of income, wealth and power. The theory recognises the interaction of economic activities with politics, society and institutions, which recognises that the nexus of contracts of a company is not only between management and shareholders but other stakeholders as well (Haniffa, 1999). Gray et al. (1984) argued that the influence of governments in the development and use of accounting systems facilitates the provision of information for national economic planning and control. There was evidence that managers adjust accounting information in response to changes in potential political costs (Cahan, 1992) and that disclosure was made to avoid intervention by government agencies, taxation authorities as well as possible claims by political and consumer groups (Gray and Roberts, 1989). The disclosure theory often discussed in the literature, derived from the political-economic theory, is the legitimacy theory.

Closely related to political-economic theory is socio-economic theory (e.g. Cooper, 1980; Tinker, 1980). Mangos and Lewis (1995) argued that accounting should '... integrate elements of economics and other social sciences into one system, but not fuse them', which has a greater potential in explaining and predicting managers' selection of information to disclose. Such an approach still recognises the importance and influence of economics on disclosure but includes sociological factors which might have an impact on the behaviour of managers in practice. Neu (1992: 223) considered this approach to be providing a more complete understanding of factors that affect managers' behaviour as it recognises the 'embeddedness of mangers in social settings', unlike the economic theory which failed to explicitly consider the role of corporate personality (Sorter and Becker, 1964). Another major drawback of economic theory is its assumption that managers discharge duties in a self-interested way to maximise their own interest (Hines, 1989). However, under socio-economic theory, it believes managers also discharge their duties by acting in some morally and socially responsible way and that they try to maximise the satisfaction of society in which they operate (Haniffa, 1999). In addition, socio-economic theory recognises a wider base of stakeholders compared to the economic and political-economic theory and believed that companies are operated for the benefit of all participants. It also recognises the need for companies to be aware of a holistic view to cater to shareholders in the form of income responsibilities and to the society at large in the form of social responsibilities. Based on Bedford's (1973) theory of 'right to know', the notion is that the public has the right of access to information on activities in which it is involved. Hence, the theory of disclosure should no longer be confined to disclosure of information only useful to creditors, shareholders, employees and management but rather would be an accountability report of the company's contribution to the society at large. However, one of the problems faced by companies is when there is a divergence in the firm's objectives and society's social goals. After consideration of the pros and cons, companies have to decide on which goal the firm wants to pursue. In addition, those in favour of the theory suggest that apart from the society's rights to information, firms should report their achievements as it is a good public relations vehicle and disclosure beyond the normal level will lessen the chance of government intervention and societal restrictions on the firm (see Haniffa, 1999). Therefore, the existence of unfulfilled rising expectations and the presence of changing public values force corporations to seriously consider disclosing more information, especially value-relevant IC information. The theory derived from this paradigm is stakeholder theory.

Legitimacy and stakeholder theory will now be reviewed in turn in the following sections.

3.1.2.1 LEGITIMACY THEORY

Legitimacy theory is closely linked to stakeholder theory. It relies on the notion that there is a 'social contract' between the firm and the society in which it operates (Brown and Deegan, 1998).[6] The theory posits that organisations are required to be responsive to the environment in which they operate and continually seek to ensure that they operate within the bounds and norms of their respective societies, i.e. to ensure their activities are perceived as legitimate (Brown and Deegan, 1998, Deegan, 2000). From the perspective of legitimacy theory, a firm would voluntarily report on activities if the management perceived that this was what the community expected. When firms find themselves unable to legitimise their status on the basis of the hard assets that are traditionally recognised as the symbols of corporate success, they may disclose IC information on how the firm invests and manages its IC to generate value to respond to public pressure and appear legitimate in the eyes of society in order to avoid the imposition of costs arising from non-legitimacy (Guthrie et al., 2006; Beattie and Thomson, 2007).

3.1.2.2 STAKEHOLDER THEORY

Corporate disclosure can also be directed to stakeholders other than investors (Healy and Palepu, 2001). According to stakeholder theory, a firm's management is expected to undertake activities deemed important by their stakeholders and to respond to the information requirements on those activities back to the stakeholders (Guthrie et al., 2006); and all stakeholders have a right to be provided with information on how organisational activities affect them, even if they choose not to use the information, and

[6] The social contract is a way of describing the multitude of expectations that a society has on how an organisation should operate (Guthrie et al., 2006).

even if they cannot play a direct constructive role in the survival of the organisation (Deegan, 2000). Stakeholder theory highlights organisational accountability beyond simple economic or financial performance. It suggests that organisations will elect to voluntarily disclose information over and above mandatory requirements, in order to meet stakeholder expectations.

Rapid changes in general economic and financial conditions, increased incidence of fraud, and the immense complexity of corporate enterprises (Haniffa, 1999) all contribute to cast doubt upon established claims to relevance, credibility, trustworthiness and decision usefulness of current financial reports. These have illustrated flaws in the accountability of accounting and the fragility of accounting practices as a basis for decision-making (Nielsen and Madsen, 2005).

With regard to decision usefulness, the purpose of financial accounting is to provide users of financial statements with information that is useful for efficient decision making (e.g. Cramer Jr. and Sorter, 1974; FASB, 1978). It is suggested that any event that is likely to affect a firm's current financial position or its future performance should be reported in its annual accounts (Cañibano et al., 2000). Intangibles are a major source of uncertainty (Lev, 2001; Meritum, 2002) for the investment community, and have also been seen largely as an integral part of firms' value-creating processes (e.g. Bukh, 2003; Holland, 2003). To resolve the problem of increasing uncertainty with regard to IC, stakeholders will demand stronger accountability and more stringent disclosure. Thus, investors and other stakeholders seek greater IC information in order to make rational economic decisions (e.g. Eccles and Mavrinac, 1995; Mavrinac and Boyle, 1996; Holland and Doran, 1998; Holland, 2001, 2003; Beattie and Pratt, 2002). Based on the managerial branch of the stakeholder theory, IC disclosure may respond to the information requirements of stakeholders about the most critical asset to the ongoing survival and future performance of the firm.

The ethical branch of stakeholder theory appears to offer an alternative explanation. Firms recognise that different stakeholders have a right to IC information and so disclosure is responsibility-driven (Beattie and Thomson, 2007). Edvinsson (1997) refers to a 'tentative new balance sheet' in which IC is borrowed from stakeholders such as customers and employees, in parallel with the financial capital borrowed from shareholders and financial institutions. Hence, a firm's management has the responsibility of disclosing IC information to stakeholders as what they do for financial and tangible assets.

3.1.3 POSITIVE ACCOUNTING THEORY

Apart from the abovementioned theories proposed by researchers to explain disclosure practices, many others used positive accounting theory. Positive accounting theory deals with management's motives in making accounting choices. If firm managers' interests are aligned with shareholders, IC information will be disclosed if it brings benefits to the firm, according to positive accounting theory (Beattie and Thomson, 2007).

Financial disclosure is defined by Gibbins et al. (1990) as 'any deliberate release of financial information, whether numerical or qualitative, required or voluntary, or via formal or informal channels' (p.122). The level and form of disclosure will vary across firms, depending on the anticipated economic consequences of disclosure or non-disclosure. This is because firms providing information have potential costs (e.g. transaction and proprietary costs) and benefits.

Primary motivators of IC disclosure include, for instance, enhancing corporate image and reputation (Toms, 2002)[7], improving the market's understanding (Graham et al., 2005), lowering perceived level of risk (e.g. Benston, 1976; Barry and Brown, 1986; Edvinsson and Malone, 1997), restoring/maintaining investor trust and confidence in a

[7] Disclosure of IC information could be self-perpetuating in terms of maintaining and enhancing IC value given that 'intangible asset creation occurs through enhanced reputation and disclosure influences the external perception of reputation' (Toms, 2002).

firm's value creation processes (Barry and Brown, 1986; Holland, 1997; Van der Meer-Kooistra and Zijlstra, 2001; Beattie and Thomson, 2005), and achieving high and stable share prices (Gibbins et al., 1990; Holland, 1997; Rylander et al., 2000). Barton and Waymire (2003), focusing on a sample of common stocks traded on the NYSE during October 1929, found a positive relation between the quality of financial reporting, in terms of transparency and credibility, and investor protection. They argue that firms with high quality financial information, prior to 1929, suffered a smaller decline in their share prices during the market crash. A number of empirical studies demonstrate that firms able to make meaningful disclosures about their long-term prospects achieve more satisfactory market valuations (Aboody and Lev, 1998; Gu and Lev, 2001).

IC disclosure can also be seen as an opportunity to lower the cost of capital (e.g. Lang and Lundholm, 1993; Baiman and Verrecchia, 1996; Stulz, 1999; Lev, 2001; Vergauwen and Van Alem, 2005), by reducing information asymmetry (e.g. Diamond and Verrecchia, 1991) and lowering transaction costs and the information risk premium. Barry and Brown (1985, 1986) and Merton (1987), cited in Graham et al. (2005) argue that when managers have more information than outsiders, investors demand an information risk premium. Firms can reduce their cost of capital by reducing information risk through increased voluntary disclosure. The argument is also supported by Clarkson et al. (1996), i.e. that greater disclosure reduces the estimation risk associated with investors' assessments of the parameters of an asset's return or payoff distribution. Further, IC disclosure increases demand for a company's shares, which consequently enhances its stock market liquidity and market value (e.g. Diamond and Verrecchia, 1991; Kim and Verrecchia, 1994; Meek et al., 1995; Welker, 1995; Baiman and Verrecchia, 1996; Beattie and Thomson, 2005; Graham et al., 2005),[8] increases

[8] According to the stock compensation hypothesis, managers have an incentive to disclose private information that will reduce insider trading and enhance the liquidity of the firm's stock since they are compensated with stock option grants or stock appreciation rights (see Healy and Palepu, 2001).

analyst followings and leads to more accurate analyst forecasts (e.g. Gibbins et al., 1990; Lang and Lundholm, 1996; Healy and Palepu, 2001; Vanstraelen et al., 2003).[9] Other benefits of voluntary disclosure include signalling management talent.[10]

Conversely, the non-reporting of IC externally will result in investors lacking information on the development of a company's intangible resources, resulting in a higher investor risk perception, and systematic undervaluation by investors (Amir and Lev, 1996; Francis and Schipper, 1999; Lev, 2001; Holland, 2003; Beattie and Thomson, 2005). Graham et al. (2005) suggest that firms voluntarily disclose information to facilitate 'clarity and understanding' to investors, and it is believed by executives that lack of clarity can lead to under-pricing of a firm's stock. In a survey by Eccles and Mavrinac (1995), sixty-five per cent of the managers of high-tech firms thought their firms' shares were significantly undervalued. Other risks associated with the underassessment of IC in the analysis of the financial position of a firm include high volatility of share prices, underestimation of future earnings and excessive cost of capital to IC-intensive firms, hindering innovation and growth (Lev, 2002a; Leadbeater, 2000; Van der Meer-Kooistra and Zijlstra, 2001). This is in line with Cañibano et al.'s (2000) argument that if financial statements provide investors with biased estimates of a firm's value (the book value of equity) and its capability to create wealth in the future, inefficiencies may appear in the resource allocation process of the capital markets.

However, there are those who are of the opinion that IC disclosure, even if feasible, has its problems. Reluctance to disclose IC information may arise from the fear of loss of competitive advantage (i.e. proprietary costs),[11] or to avoid litigation and increased

[9] Voluntary disclosure reduces the cost of information acquisition for information users and increases the amount of information available, and hence attracts more analysts (Graham et al., 2005).

[10] Graham et al. (2005) argue that a talented manager has an incentive to make voluntary disclosures to signal his or her type. In addition, managers are held accountable for stock misevaluation and poor performance. Thus, managers are also likely to increase the level of disclosure in order to reduce stock misevaluation, or to explain poor performance, based on corporate control contest hypothesis (Healy and Palepu, 2001).

[11] Costs resulting from the disclosure of potentially damaging information (to the firm's competitors) are deemed proprietary costs (Lang and Lundholm, 1993; Skinner, 2007). Gibbins et al. (1990) argue that on the one hand, managers wish to protect proprietary information in order to exploit its potential economic advantages, while on the other hand, they wish to disclose information to

political and agency costs (see Watts and Zimmerman, 1986; Gibbins et al., 1990; Healy and Palepu, 2001; Verrecchia, 2001; Graham et al., 2005; Beattie and Thomson, 2007). Other costs of IC disclosure include the commitment cost of increasing voluntary disclosure (e.g. increased cost of new rules and bureaucracy in the organisation), tax consequences if included on the balance sheet, reduced freedom of management and the creation of higher expectations (Van der Meer-Kooistra and Zijlstra, 2001). Graham et al. (2005) found that managers attempt to avoid setting disclosure precedents that will be difficult to maintain. IC disclosure is also open to the risk of a firm's management using intangibles for widespread manipulation of financial information or insider trading (Aboody and Lev, 2000; Lev, 2002a).[12] Costs related to disclosure could discourage information dissemination (Dye, 1985; Verrecchia, 2001).

Basic concepts of economic rationality would lead one to conclude that a firm would provide IC information required by information users to the point where the marginal cost of providing the information does not exceed its anticipated marginal benefit.

The different foci of the abovementioned disclosure theories supplement each other and build a richer understanding of IC disclosure practices. The following section provides a discussion of the factors that potentially influence IC disclosure practice.

3.2 FACTORS AFFECTING IC DISCLOSURE

In-depth studies have shed light on the process of corporate voluntary disclosure and the market for information (e.g. Gibbins et al., 1990; Barker, 1998; Holland, 1998, 2001, 2003, 2004, 2006a, b; Graham et al., 2005). Given the discussion of theoretical explanations for disclosing or not disclosing IC information, what are the determinants of IC disclosure practice? IC research on disclosure practices is largely silent about what

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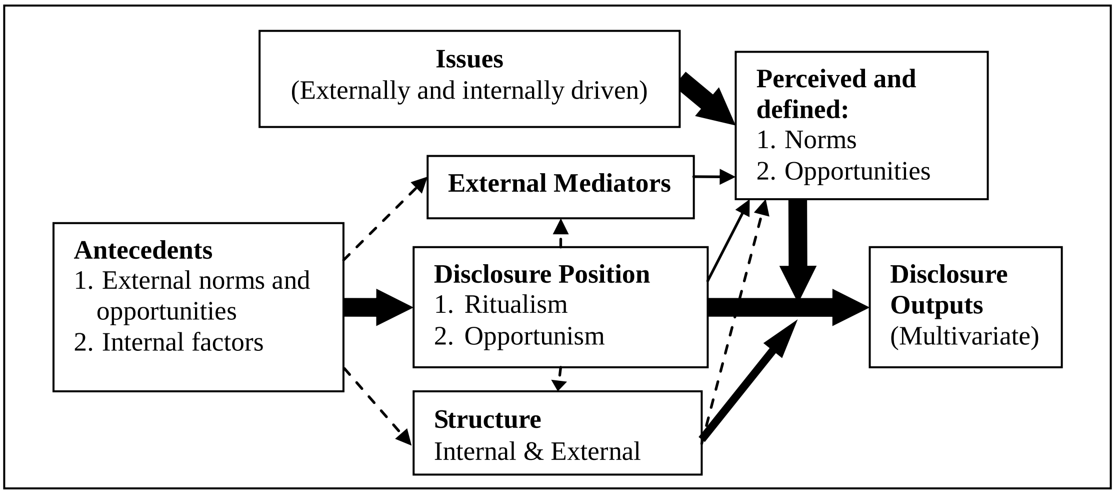
enhance the firm's value. Adams (1997), Healy and Palepu (2001) and Williams (2001) also suggest that firms manage information disclosed to investors in order that they do not disclose information affecting their competitive advantage.

[12] Walmsley et al. (1992) found that the company meetings organised by the Society of UK Investment Analysts were associated with increased price volatility and this is consistent with trading on privileged information derived from such meetings. Their research suggests that private company meetings with analysts and institutions arranged just after the results announcements also have potential for the release of price sensitive information for insider trading.

determines such practice. The purpose of this section is to provide a brief overview of potential determinants of IC disclosure practice.

Gibbins et al. (1990) explore the disclosure process giving rise to disclosure outputs in response to internal and external stimuli. They argue that a firm's readiness to provide disclosures is a function of its general disclosure position (for example, ritualism which is an uncritical adherence to information disclosure norms; or opportunism, which is to use disclosure as opportunity to seek firm specific advantage such as to boost stock price), antecedents (for example, internal antecedents including corporate history, corporate strategy, and internal politics; and external antecedents including institutional and market factors), the existence of internal or external structures for handling disclosure, and the use of auditors, consultants, advisors or other external mediators.[13] The theoretical model of corporate disclosure process developed by Gibbins et al. (1990) is reproduced and shown in Figure 3.1.

Figure 3.1 Theoretical Framework for Corporate Disclosure Process



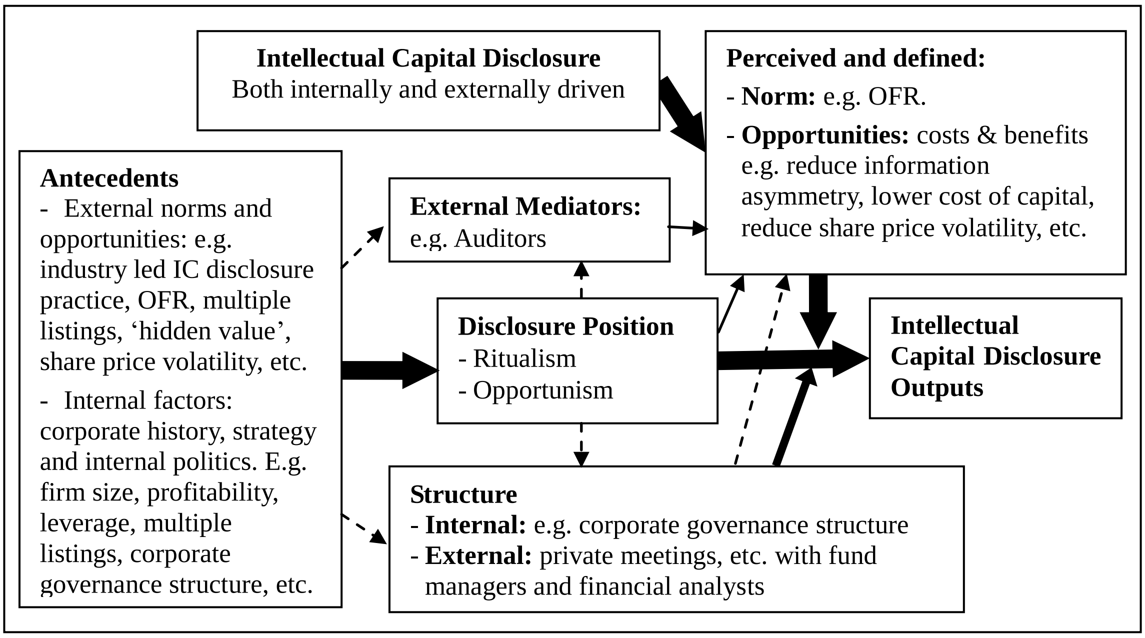
Source: Gibbins et al. (1990: 128)

This process of corporate financial disclosure can be applied to IC disclosure. Figure 3.2 shows the adapted theoretical model for the process of IC disclosure based on Gibbins et

[13] Disclosure position is defined as a relatively stable preference for the way disclosure is managed. Ritualistic behaviour has been described as repetitive, routinised, involving passive roles for managers that well-known standardised processes arising from internal behavioural patterns are employed. Opportunism is a managerial predisposition to behave in a particular way, but through active stances in which disclosures are seen as opportunities to reap specific benefits by managing the disclosure process. (see Gibbins et al., 1990)

al. (1990). The issue of IC disclosure is both internally and externally driven. Indeed, the IC movement is undeniably grounded in practice (Roos et al., 1997; Mouritsen, 1998; Petty and Guthrie, 2000). Endeavours to reconstruct corporate annual reporting to include IC indicators were spearheaded in the early 1990s by a small number of corporations. Among the pioneers were corporations like the Swedish Insurance company Skandia, the Danish company Rambùll and the Dow Chemical Company. On the other hand, as discussed previously, the increasing dependence of firms on IC in creating competitive advantage and value and the inability of traditional accounting to report such assets result in the increasing gap between market and book values of firms and growing information asymmetry. This has led to increasing demand for external IC communication by the market (e.g. Holland, 2001, 2003).

Figure 3.2 Theoretical Framework for IC Disclosure Process



As discussed in Section 3.1, the process of IC disclosure centres on cost/benefit trade-offs (Beattie and Thomson, 2007), i.e. norms and opportunities consideration. Although it has been argued that there is a lack of a uniform IC definition and reporting framework, there is evidence of formulation of norms for voluntary IC disclosure (e.g. the non-mandatory recommendations for textual disclosure from the UK's Operating and Financial Review, OFR, and the requirements for the inclusion of Management's Discussion and Analysis in the U.S.) (Beattie and Thomson, 2005; Lennard, 2007). Firms, therefore, respond to market and regulator determined requirements for good practice in IC disclosure behaviour and content (Holland, 2006a: 19) to satisfy 'voluntary' good practice guidance and market benchmarks. A brief review of the development of OFR is provided in Appendix 3-A. In addition, a firm's management has various incentives, as discussed in Section 3.1, to signal the critical success factors of the firm so as to, for example, reduce information asymmetries, agency costs and share price volatility, and to enhance the firm's credibility, reputation and share price.

IC disclosure is also determined by a firm's disclosure position, opportunism or ritualism, dependent on prior internal and external factors. Prior internal factors could include such things as a firm's size, which partly determines a firm's reporting tradition and learning capability. Large firms are more likely to be under greater pressure for information disclosure, [14] and hence are more open and advanced in information dissemination processes. In addition, larger firms that have a broader set of management and accounting routines are found to be more pronounced in the implementation of IC management systems compared to small and medium size firms (Chaminade and Roberts, 2003). Thus, a firm's size could be expected to have an effect on its IC disclosure position. Other internal factors such as profitability, level of leverage and listing age could form part of a firm's tradition in IC communication to the public. A firm's corporate strategy in terms of, for instance, multiple listings[15] and industry sector could also form part of the internal factors that affect a firm's IC disclosure position. In addition, as suggested in Gibbins et al. (1990), internal politics form part of the prior internal factors that influence decisions about corporate disclosure, e.g. the 'CEO effect'.

[14] Firm size can also be considered as an external institutional factor that influence a firm's disclosure position.
[15] Multiple listing could be considered as both prior internal and external factors, given that it reflects both a firm's strategic decision on its listing status and the information disclosure requirements of different stock markets.

Therefore, issues of corporate governance can be considered as prior internal factors that affect a firm's IC disclosure position. Prior external factors could include, for instance, 'hidden value', share price volatility, share turnover and multiple listings. These factors affect a firm's decisions on whether to disclose or not to disclose its critical success factors based on the cost/benefit trade-offs perceived by the firm's management. It can be expected that firms with, for example, greater 'hidden value', higher share price volatility, international stock market listings, larger size and good corporate governance structure in place, are more likely to take the opportunistic disclosure position to reap the associated potential benefits, taking into consideration the costs involved.

Furthermore, a firm's IC disclosure process could be determined by its internal and external structures in place to respond to the information requirements of the market. Structures are argued to be the general activating force of corporate disclosure (Gibbins et al., 1990). The existence of structure will lead to more disclosure activity for a given issue or given disclosure position (Gibbins et al., 1990). Internal structure is the extent to which responsibility for the management of the disclosure process is assigned to particular positions within the organisation and/or is guided by clearly understood policies and procedures. Corporate governance structures are highly relevant to internal structures, which involve establishing clear policies, guidelines and procedures to review both opportunistic and ritualistic corporate disclosure, including IC disclosure. Thus, it can be expected that well-defined corporate governance structures (e.g. audit committee function) lead to greater IC disclosure. External structure is defined as the extent to which external demands for information are channelled through organisations that claim to represent third-party interests (Gibbins, et al., 1990: 133), such as private communication channels. Prior studies examining the external structure of IC disclosure include Holland (1997, 1998, 2001, 2003, 2004, 2006a, b), which focus primarily on information disclosure from firms to more sophisticated information users, such as fund managers and financial analysts.

Other determinants of IC disclosure process include external mediators, such as auditors and consultants. This is supported by Thomas' (1989) argument that in order to cope with environmental change and uncertainty, a firm will rely on professional specialists (e.g. accountants and auditors) that will exert their influence on corporate strategy, including disclosure decisions, as cited in Adams (1997).

Apart from Gibbins et al.'s (1990) framework, the literature suggests that firms develop disclosure strategies in response to both internal and external stimuli (e.g. Holland and Stoner 1996; Adrem, 1999). Many researchers in accounting and financial reporting believe that characteristics of the business and economic environment affect corporate disclosure behaviour (e.g. Cooke and Wallace, 1990; Haniffa and Cooke, 2002, 2005; Graham et al., 2005). As argued by Haniffa (1999), the constitution of internal factors varies at the micro and macro level. At the macro level, as suggested in Cooke and Wallace (1990), internal environmental factors that have impact on the practice of corporate disclosure include the level of education, cultural aspects and political and economic systems.[16] At the micro level, internal factors are factors related to the individual firm. To understand the influential factors of IC disclosure practice better, especially in the context of this thesis, the rest of this chapter devotes its attention to 1) two types of internal factors at the micro level, namely, corporate governance and company characteristics, and 2) some external factors (market factors). This provides a framework of determinants of IC disclosure.

3.2.1 INTERNAL FACTORS

The internal factors that could potentially affect IC disclosure practice of individual firms discussed in this thesis are twofold: 1) corporate governance factors and 2)

[16] Various factors of such as economical, political and legal system have been examined in the literature (see Haniffa, 1999).

company characteristics. This section reviews company characteristics first, followed by a review on corporate governance factors.

3.2.1.1 COMPANY CHARACTERISTICS

Prior empirical studies have recognised the relationship between various company characteristics and the extent of disclosure, such as disclosure in general (e.g. Singhvi and Desai, 1971; Patton and Zelenka, 1997), general voluntary disclosure (e.g. Chow and Wong-Boren, 1987; Cooke, 1991, 1993; Craswell and Taylor, 1992; Raffournier, 1995; Haniffa and Cooke, 2002; Ferguson et al., 2002; Patelli and Prencipe, 2007), corporate social responsibility disclosure (e.g. Cowen et al., 1987; Belkaoui and Karpik, 1989; Brammer and Pavelin, 2004; Haniffa and Cooke, 2005), environmental disclosure (e.g. Cormier and Magnan, 1999, 2003; Cormier et al., 2005; Brammer and Pavelin, 2006)[17], corporate risk reporting (e.g. Beretta and Bozzolan, 2004; Linsley and Shrives, 2006; Abraham and Cox, 2007), segmental disclosure (e.g. McKinnon and Dalimunthe, 1993; Prencipe, 2004) and internet reporting (e.g. Craven and Marston, 1999; Debreceny et al., 2002; Xiao et al., 2004).

Company characteristics considered as possible predictors of corporate disclosure were classified into three non-mutually exclusive categories, which are structure-related, performance-related and market-related variables (Wallace et al., 1994).[18] The ones that are commonly examined in the prior disclosure literature include firm size, industry type, type of auditor, listing status, leverage, profitability, and liquidity. Ahmed and Courtis (1999) provide a meta-analysis of twenty-nine disclosure studies of the associations between company characteristics and disclosure in annual reports and observe generally significant and positive relationships between disclosure level and firm size and listing

[17] Gray et al. (1995b) provide a review of corporate social and environmental reporting studies.
[18] Wallace et al. (1994) and Haniffa (1999) provide detailed reviews on these three types of company characteristics. Structure-related variables refer to those that describe a firm on the basis of underlying structure, e.g. size and leverage. Performance-related variables are those that vary from time to time and represent information that may be of interest to account users, e.g. liquidity and profitability. Market-related variables are qualitative in character and categorical, which may be time-period specific and/or relatively stable over time, and may be within or outside the control of the firm, e.g. industry, listing status, type of auditor.

status. Haniffa (1999) and Chavent et al. (2006) also provide reviews of prior disclosure studies. A summary of some of the prior disclosure studies is provided in Appendix 3-B.

The effect of company characteristics, such as firm size, age, profitability, leverage and industry type on IC disclosure practice has also been examined (e.g. Bontis, 2003; Bozzolan et al., 2003; García-Meca et al., 2005; Cerbioni and Parbonetti, 2007; Sujan and Abeysekera, 2007; White et al., 2007). A review is provided in Chapter 2, Section 2.3 (also see Appendix 2-B) and in the development of hypotheses section in Chapter 6.

In the review of disclosure studies of the associations between company characteristics and disclosure in annual reports, Ahmed and Courtis (1999: 36) suggested that the inconclusive results between level of voluntary disclosure and factors such as profitability and leverage could be due to ‘differences in socio-economic and political environments between countries, organizational structures, construction of the information items in disclosure indices and sampling error’. However, Gul and Leung (2004: 355) proposed that the ‘failure to include corporate governance characteristics could account for the inconsistent results since corporate disclosure policies emanate from the board’. Hence, the next section reviews corporate governance factors.

3.2.1.2 CORPORATE GOVERNANCE

Corporate governance may be broadly defined as ‘the manner in which firms are controlled and in which those responsible for the direction of firms are accountable to the stakeholders of these companies’ (Dahya et al., 1996: 71; cited in Haniffa and Cooke, 2005). Similarly, Weimer and Pape (1999) define corporate governance as a framework of legal, institutional, and cultural factors shaping the patterns of influence that stakeholders exert on managerial decision-making. The two key elements of governance concern supervising or monitoring management performance and ensuring accountability of management to shareholders and other stakeholders (Tricker, 1984).

Viewing firms as a nexus of explicit and implicit contracts (Jensen and Meckling, 1976; Fama and Jensen, 1983a), Garvey and Swan (1994) assert that 'governance determines how the firm's top decision makers actually administer such contracts' (p.139). Given the pervasive differences between the interests and incentives of managers and providers of finance, and the limitations of principal-agent contracting (see Section 3.1.4 for a discussion), there is a need for additional monitoring via the implementation of a set of corporate governance mechanisms that help to assist in aligning the incentives of managers with those of shareholders, and hence reduce agency problems. Boards of directors are appointed to act as monitors on managers' activities, protecting the interests of shareholders. The responsibility of the board is to govern the firm, while management's task is to manage the firm. Within this context, boards perform the critical function of monitoring and rewarding top executives to ensure maximisation of shareholders' wealth, where the board is seen as the ultimate mechanism of corporate control (Zahra and Pearce II, 1989).

The reasons for the growing interest in corporate governance have been described as due to, for instance, the questioning of the efficiency of the prevailing governance mechanisms (e.g. Jensen, 1993; Miller, 1997; Porter, 1997), the 'proliferation of firms, the complexity of corporate groups, and problems of ensuring adequate accountability and corporate responsibility in an increasingly global business world' (Tricker, 2002: 2),[19] criticisms of the financial reporting function as being unable to fulfil information demands by information users, the spread of creative accounting, the ease of unprincipled management in expropriating stakeholders' resources, the limited role and lack of independence of auditors and geographic dispersion of shareholders (Macdonald and Beattie, 1993).

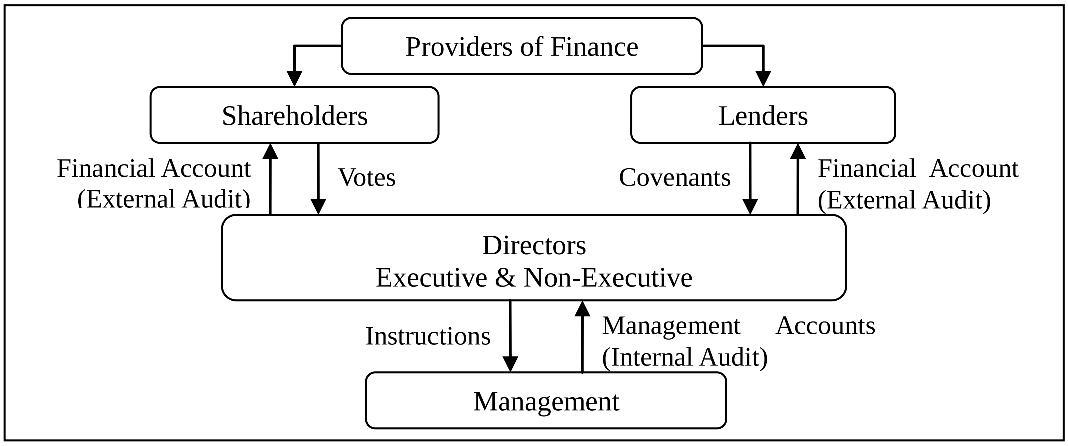
[19] This debate has intensified following reports about spectacular, high-profile financial scandals and business failures (e.g. Polly Peck, BCCI, Maxwell Communication and Enron), and media allegations of excessive executive pay.

So far, the importance of corporate disclosure and corporate governance, both as control mechanisms, has been discussed. The next section aims to provide a review on the link between the two issues.

3.2.1.2.1 CORPORATE GOVERNANCE AND FINANCIAL REPORTING

The link between the two control mechanisms, i.e. corporate governance and corporate disclosure, the former being an internal, and the latter an external, has long been established based on agency theory, whereby both are designed to mitigate the agency problem arising from the separation of ownership and management. Williamson's (1985) analysis of transaction costs provides a framework linking disclosure to corporate governance, and this is integrated with the positive theory of agency developed by Jensen and Meckling (1976) to provide a model of the disclosure decision of management. Core (2001: 444) argues that voluntary disclosure and corporate governance are interlinked, creating an endogenous relation between information asymmetry, disclosure quality and corporate governance. Whittington (1993) provides a model which links the system of corporate governance to the regulation of financial reporting based on existing practices in large listed firms in the UK. The model is developed from the perspective of providers of finance for firms, shown in Figure 3.3.

Figure 3.3 Model of Corporate Governance: A Schematic View of the UK System of Corporate Governance



Source: Whittington (1993)

In order to ensure accountability of the directors, shareholders and providers of loan capital need financial and non-financial information, which allows them to exercise their ownership rights on an informed basis, and thus monitor directors' behaviour and assess the performance of the firm. However, the restriction of inside information to external parties (e.g. providers of finance), which is accessible by directors, creates information asymmetry. Financial reports from directors to providers of finance are one of the means of reducing this asymmetry, thus limiting the effects of the moral hazard problem to which directors might be susceptible.[20]

Therefore, management has a stake in the financial reporting environment and plays an important role as the preparer of financial statements and a supplier of financial information (Beaver, 1998). Gibbins et al. (1992) contend that the degree to which sub-units or individual managers in the organisation are given discretion over disclosure decisions will determine the nature of the entity's disclosure strategy. Indeed, Gordon and Miller (1976) also consider that management perceptions of environmental uncertainty (i.e. opportunities and threats) have a major impact on the nature and the form of accounting information produced by the organisation. Management is assumed to balance potential benefits from greater disclosure against costs, and to choose the level of disclosure which minimises the costs they incur (e.g. Gibbins et al., 1990; Roslender and Fincham, 2004; Graham et al., 2005). Gibbins et al. (1990, 1992) and Forker (1992) also acknowledge the importance of opportunism in corporate politics and the influence which dominant personalities may have in the corporate reporting process.

Whittington (1993) argues that reporting is necessary for the corporate governance system to function effectively and that problems of financial reporting are partly due to

[20] Accountability is a fundamental part of corporate governance, which involves the monitoring, evaluation and control of organisational agents to ensure that they behave in the interests of shareholders and other stakeholders (Keasey and Wright, 1993). The role of financial reporting is inextricably linked with the process of corporate accountability. An early understanding of financial reporting was as a stewardship function where management acts as stewards to whom suppliers of capital entrust control over their financial resources. In this context, the role of financial reporting was to provide an assessment of the stewardship of management to the suppliers of capital. This information, or signalling, role has obvious implications for the process of corporate accountability in that it helps to reduce the information asymmetry between managers and stakeholders (see Ormrod and Cleaver, 1993).

an ineffective corporate governance system. In addition, it is argued that disclosure changes are likely to coincide with changes in a firm's economic condition (e.g. earnings performance) and governance structure (Healy and Palepu, 2001). Gibbins et al. (1990) argue that firms are predisposed to ritualistic and opportunistic behaviour in the management of corporate disclosure as a result of antecedents, which include corporate governance structure, such as the firm's ownership-control structure. Differences in firms' disclosure positions can be expected to emanate partly from their ownership structure, e.g. UK firms typically have diffused share ownership structure, which makes it difficult for the 'principals' to monitor and control the behaviour of the 'agents', compared with firms with more concentrated share ownership structure, and hence are under greater pressure for disclosure, especially on value-relevant IC information, to reduce information asymmetries and agency costs.

Moreover, as discussed in an earlier section, corporate governance mechanisms are highly relevant to internal structures (i.e. the general activating force) for the disclosure process (Gibbins et al., 1990). The existence of such structures will lead to more disclosure activity for a given issue or given disclosure position.

Adoption of internal control devices, such as audit committees and non-executive directors and separation of the roles of chairman and chief executive, enhances monitoring quality and reduces benefits for the management from withholding value-relevant information and, as a consequence, improves disclosure, including IC disclosure, in annual reports.

3.2.1.2.2 CORPORATE GOVERNANCE AND IC DISCLOSURE

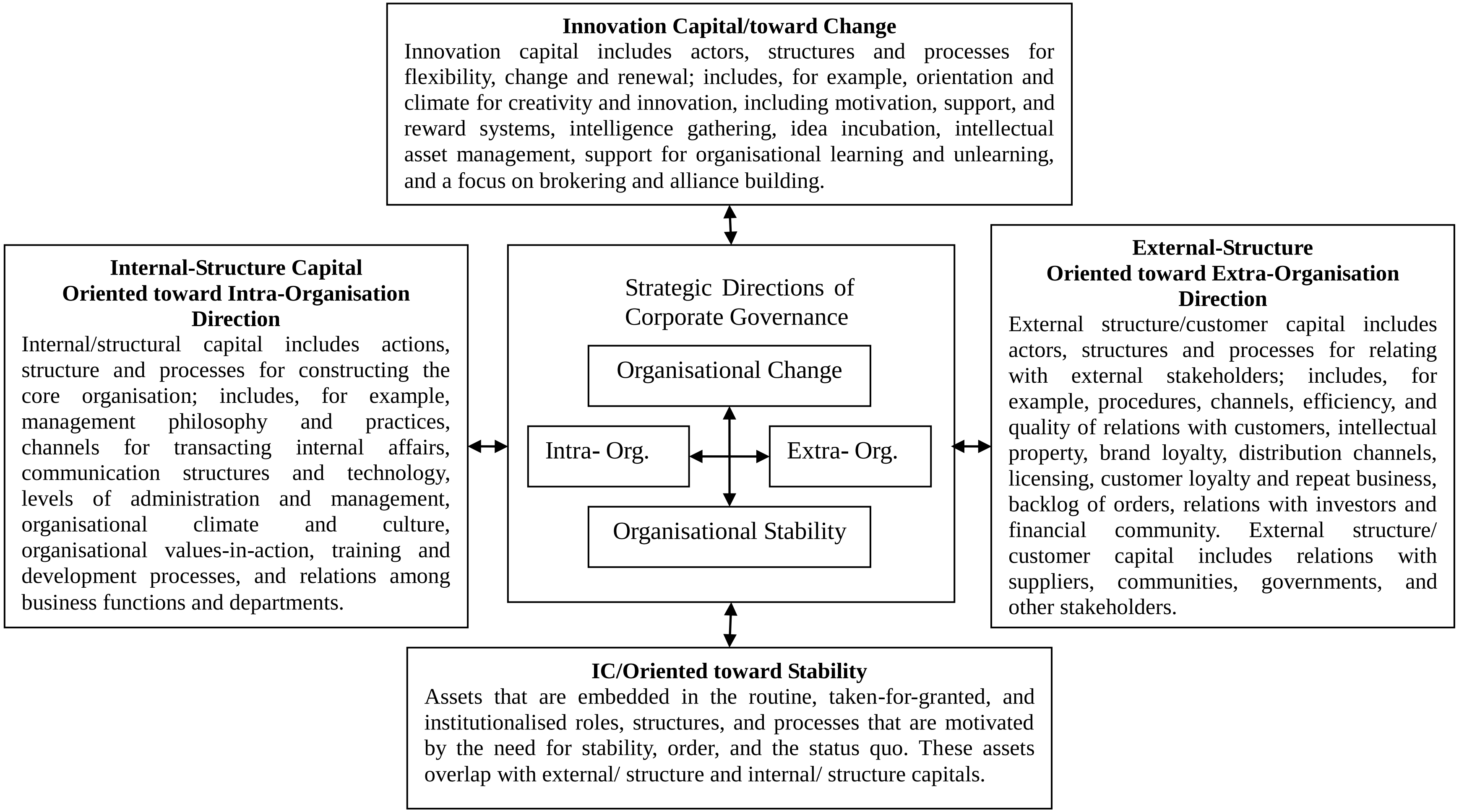
One of the persistent problems facing corporate governance is the increasing shift toward knowledge-intensive organisations (Keenan and Aggestan, 2001: 259). Research and practice, traditionally concerned with governance responsibility for financial and physical capital, has not focused much on the relations between governance and IC. Corporate governance and IC are two topics that have received increased, but separate, interest by both researchers and practitioners. Keenan and Aggestam's (2001) study was one of the first to develop a conceptual framework that marries IC and corporate governance and illustrates their connections and potential synergies.

Keenan and Aggestam (2001) argue that investor perceptions and judgements about the quality of a firm and its governance are made, directly and indirectly, on the basis of the firm's adroit use of assets including financial, physical-plant and IC to create value. Corporate governance would need to direct and influence the development and management of a firm's IC as a system of business assets (along with financial and physical assets) and to assure communication to investors about the deployment and performance of such assets. The success of a firm in the stock market can be, in some measure, attributable to reporting information about the firm's IC to investors (Edvinsson, 1997).

Keenan and Aggestam's (2001) framework illustrating the relationship between IC categories and corporate governance activities of enterprises is shown in Figure 3.4. The authors argue that it is the role of corporate governance to achieve both organisational stability and change through prudent investment and management of IC, i.e. assuring, mobilising and orienting human, culture, innovation, external-structure, and internal-structure capital, oriented toward achieving the goals and values of the firm. The structure of a firm's corporate governance, at least in part, determines its capability to respond to changes in business and economic conditions and the increasing demand for IC information by various stakeholders (Gibbins et al., 1990). As such, IC disclosure is rooted in the responsibility of corporate governance.

IC disclosure is a form of external control providing information to shareholders about

Figure 3.4 IC and Corporate Governance Paradigm (Source: Keenan and Aggestam, 2001: 263[21])



[21] Innovation capital is oriented toward dramatic organisational change. Internal/structural capital is focused on the resourcefulness of intra-organisational structures and processes. External/customer capital is focused toward extra-organisation relations. The paradigm does not include human capital in the mapping. Human capital and one other category of IC, i.e. societal/culture capital, are argued to be cutting across the other capitals in the IC paradigms and directed toward all four governance orientations simultaneously: organisational change and stability, and extra-organisational and intra-organisation relations and activities.

value–relevant information not incorporated in financial statements. Deciding on the level of IC disclosure allows management to influence the level of uncertainty faced by investors in estimating IC and therefore a firm's value. The greater the uncertainty, the less effective will be the monitoring of IC, and the greater the potential use of such assets by the management to pursue self-interest at the cost of stakeholders. Therefore, better IC disclosure provides a more 'intensive monitoring package' for a firm to reduce managerial opportunistic behaviour and information asymmetry (Welker, 1995). As IC disclosure is selective and not all managerial manipulation can be avoided, an association between the relevance of governance structure and the influence on managers to improve their IC disclosure policies could be expected (see Buzby, 1975; Cooke, 1989a, 1993; Ahmed and Nicholls, 1994). Appropriate corporate governance diminishes the possibility that management will enhance their interests by using IC information asymmetries, which can also act to ensure greater IC disclosure.

Holland (2006a: 147) evidenced that boards of directors are at the heart of corporate financial communications, where they play roles in the disclosure process related to 1) the provision of primary information regarding the corporate value-creation process, and the way they were contributing to it; 2) the provision of information about themselves in terms of their skills in managing the business; 3) the manner in which they are organised to conduct financial communications; 4) their reputation for disclosure honesty; and 5) information about how their own pay and wealth were tied to company fortunes.

Depending on a firm's characteristics and orientation, the governance of publicly-owned firms may need to develop new structures and processes in annual reports for communicating information about the value created for stakeholders through the firm's IC (Keenan and Aggestam, 2001). Therefore, corporate governance mechanisms (e.g. board of directors and audit committees) have responsibility for formulating the strategic focus of, and involving themselves in critical decisions about, IC communication. It could help to explain why firms disclose (or do not disclose) IC information publicly via annual reports. It can be expected that well-defined corporate governance structure leads to greater IC disclosure. A detailed review of some of the corporate governance factors will be provided in the development of hypotheses section in Chapters 6 and 8 of this thesis. The next section provides a review of the effect of market factors on corporate disclosure, especially IC disclosure.

3.2.2 EXTERNAL FACTORS: MARKET FACTORS

Adrem (1999) argues that firm-provided information plays a role in capital market functioning, particularly in the stock market. Factors such as internationalisation, the economic development, deregulation and transition of national and international financial markets, have given rise to competition for capital and influence the pattern of the financing of firms. This in turn has led to the growth of multinational business enterprises, the wide spread of public ownership, the divorce of ownership and management, and has created far greater demand for corporate disclosure. Reliance on capital markets for financing imposes upon managers the need to reduce the level of information asymmetry between them and their investors (see Frankel et al., 1995), especially for value-relevant IC information.

Several theoretical and empirical papers established an association between corporate disclosure and capital market benefits. For example, Amihud and Mendelson (1986), Merton (1987), King et al. (1990), Diamond and Verrecchia (1991), and Healy et al. (1999)[22] demonstrate that enhanced disclosure increases stock liquidity and reduces cost of equity capital. Barry and Brown (1985) and Clarkson et al. (1996) link disclosure and cost of equity capital through reduced estimation risk. Other empirical studies exploring the effect of information disclosure on capital market include Welker (1995), Lang and

[22] Healy et al. (1999) evidenced an increase in liquidity, measured as a decline in relative bid/ask spreads, in the years following an increase in analysts' disclosure ratings.

Lundholm (1996), Botosan (1997), Adrem (1999), Bushee and Noe (2000), Richardson and Welker (2001), Botosan and Plumlee (2002), and Plumlee and Botosan (2007).

However, as argued by El-Issa (1988), accounting and corporate disclosures are not ends in themselves. It is suggested in Gibbins et al. (1990) that a firm's disclosure position is in part determined by antecedents. This suggests that the corporate disclosure process is itself continuous and reflective. Holland (2006a) suggests that communication between a firm's management and information users (e.g. analysts and fund managers) is a two-way learning system. Not only do information users learn from the information provided by firms, but managers also learn from the market. Such knowledge then helps in formulating current disclosure strategy.

In line with these arguments, previous studies also investigated the impact of market factors on corporate disclosure practice (e.g. Lang and Lundholm, 1993; Frankel et al., 1995; Frankel et al., 1999; Botosan and Harris, 2000; Bushee et al., 2003; Cormier et al., 2005; and Debreceny and Rahman, 2005). Botosan and Harris (2000) and Debreceny and Rahman (2005) examined the effect of variation in trading volume on frequency of disclosure decisions, with the latter finding that firms with higher share price volatility disclose more regularly and frequently. Frankel et al. (1999) found that firms providing conference calls had higher market-to-book ratios. These studies provide evidence that firms do respond to the demand for information disclosure by investors and other stakeholders. A more detailed review of some of the market factors' impact on IC disclosure is provided in the development of hypotheses section in Chapter 9.

It can be concluded that factors (i.e. internal and external) influencing disclosure processes have been examined theoretically and empirically, using case studies and interviews (e.g. Gibbins et al., 1990; Graham et al., 2005). Studies focusing on the disclosure process and insights into IC disclosures are also case study and interview based (e.g. Holland, 1997, 2001, 2003, 2004, 2006a, b; Roslender and Fincham, 2004). Few studies have gone beyond quantifying IC disclosure to explore the potential determinants of such disclosure behaviour (e.g. Bozzolan et al., 2003; García-Meca et al., 2005). Although previous studies have examined the association between voluntary disclosure in annual reports and corporate governance mechanisms, company characteristics and capital market factors (e.g. Adrem, 1999; Chen and Jaggi, 2000; Haniffa and Cooke, 2002; Eng and Mak, 2003), few studies have specifically addressed the associations in terms of IC disclosure. This chapter, together with the review provided in Chapter 2, forms a platform for some of the main contributions of this study.

3.3 CONCLUSION

Firstly, this chapter has reviewed the motivations for intellectual capital (IC) disclosure from theoretical perspectives. Various costs and benefits of IC disclosure have been discussed. A firm will provide IC information required by information users to the point where the marginal cost of providing the information does not exceed its anticipated marginal benefit.

Secondly, while various internal and external factors form the determinants of corporate disclosure, the link between IC disclosure, and corporate governance factors, company characteristics and market factors is established in this chapter. The theoretical underpinnings for individual factors, such as firm size and profitability, are provided in the development of hypotheses sections of Chapters 6, 8 and 9.

The review of this chapter helps build the framework of the IC disclosure process linking disclosure outputs with internal (corporate governance structure and company characteristics) and external (market factors) stimulus; it is designed to improve corporate governance and provide implications for firms' IC disclosure practice and policy making.