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Audit Committee Mechanism on Intellectual Capital Disclosure Evidence from Indian listed companies

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INTRODUCTION

Prior literature on reporting of firms has upraised a concern about the utility of traditional reporting of the firm for better decision making. Traditional reporting offer imperfect information have been criticized for their historical orientation.in this context, the importance of inculcating the non-financial information including intellectual capital into the reporting framework of the companies has arisen. The IIRC(international integrated reporting council) working on integrated reporting come up with an ample reporting framework which shows the importance of including non-financial information in the firms reporting framework. Intellectual capital(IC)has considered as an important element in non-financial information. Past literature has identified that IC information can reduce the increasing disparity amongmarket to book value of a company. Hence IC information has to consider as at most important item that has to be incorporated in the corporate reporting framework at the earliest. So, the core is that IC of a firm add value to the firm and that would reflect in the market, especially in the knowledge era where the importance of intangible assets are getting more and more.

Even though the prior literature had emphasized the significance and importance of IC information. Still, in most of the countries, it's reporting is voluntary in nature. Consequently, its reporting is still not systematic.Even though, many recent studies which are taken place in the different region and in different countries have revealed a growing tendency of disclosing non-financial information, specifically IC information. As stated before that IC are used to describe the widening disparity between market value and book value of the firm, Hence the capital market key players like investors and financial analyst are exceedingly value IC information to conclude to the right decision. Therefore there is a mounting demand to restructure the traditional reporting framework by accommodating both financial and non- financial information with which user can have a better understanding and would lead to the reduction in information asymmetry.

Before going to discuss audit committee and its mechanism, it is necessary to have an understanding about corporate governance. Corporate governance is a set of control mechanisms which safeguard the interest of stakeholders by ensuring efficient management through monitoring managerial decisions. (Donnelly and Mulcahy, 2008; Authors, 2018).Though, the corporate governance mechanism is affecting the nature and quality of firms reporting(Kothari 2000; Authors, 2018) through the audit committee mechanism.Hence audit committee considering as a key element in the corporate governance mechanism of a firm. It looks after the quality and integrity of the firm's accounting and reporting functions. Even though, the importance of corporate governance mechanism onIC reporting discussed extensively before, but more specifically,the influence of audit committee characteristics in the IC reporting has least studied. Hence, inthis endeavor, tried toinspect the importance of the audit committee to ensure extensive reporting of non-financial information, special reference to intellectual capital in the corporate reports.

The rest of this paper has organized as follows. Section 2 deals with the motivation of the study and section 3 outline the prior literature. Section 4 discussing the hypothesis development and section 5 deals with research design. Empirical results of the study have discussed in section 6 and section 7 concludes the study.

MOTIVATION FOR THE STUDY

In India, corporate governance history starts from a few decades back, different initiative has taken place bytime to time to advance the corporate governance mechanism, to ensure better governance and transparency in the corporate affairs. The Security Exchange Board of India(SEBI) has taken a lot of considerable initiative by time to time to update the corporate governance rules. The motivation for this study is coming from, the evidence that are showing the audit committee mechanism can improve the performance and reporting quality of a firm by including more non-mandatory information, particularly

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IC. The audit committee is important committee among board committees to ensure quality reporting of corporates and apart from that, country to country the rule of corporate governance will be different, audit committee mechanism also not free from this. Soin this study, we look into the role of audit committee mechanism to safeguard the qualityof reporting by including non-financial information more into corporate reports of Indian listed companies.

REVIEW OF LITERATURE

While looking into the corporate accounting and reporting allied research, there is growing literature in integrated reporting that consider financial as well non-financial facts in common reporting framework, such as intellectual capital, environmental and social aspects of firms. (Arvidsson, 2011; Abeysekera, 2013). Most of the studies having a monotone that the investors and other stakeholders of annual reports, no longer rely solely on information out of traditional financial reporting to frame their decision (Francis and Schipper, 1999; Gray, 2006).Presently, investor and other stakeholders are looking into more kind of non-financial information which deals with the capabilities of the firm other than financials. IC information, important non-financial information have been considered as crucial fordecision making for investors (Abhayawansa and Guthrie, 2010; Merkley, 2014), by the way, that information can expose other unseen matters and it can be helpful in explaining the firm financial position(Liu and Wang, 2012). A number of literature are showing that good corporate governance mechanismwould heighten the IC disclosure of firms(Ahmed Haji and Mohd Ghazali, 2013).The presentstudies areconcentrating more onthe definitespecification of corporate governance mechanisms like board structure, size and diversity (Abdul Rashid et al., 2012). Despite that, very little studies have come across about the establishment of subcommittees in the board mechanism and its effect on IC reporting.The necessity for such an investigationcomes from the faith that IC information possess a vital role in the value formation of a firm. (Tayles et al., 2007). Therefore, for the investors and other stakeholders, the disclosure drivers, those related to IC information would fetch as beneficial.(Merkley, 2014). Apparentlycan say thatthe presence of an audit committee in a firm considered as the potential driver to safeguard timely, quality corporate reporting (Ika and Mohd Ghazali, 2012). Even thoughthe impact of the audit committee on reporting of IC information to ensure quality in firm reporting has least studied(Li et al., 2012). For instance, Ho and Wong (2001) examined the effect of a non-mandatory audit committee on non-mandatory disclosure of firms in Hong Kong and identified that the presence of a non-mandatory audit committee is a notable factor which affects the disclosure. By using data from Malaysian companies, Akhtaruddin and Haron (2010) have identified that more the independence and proficiency of the audit committee would result an improvement in disclosure. by using data from 124 Malaysian listed companies.Li et al. (2012) have undertaken the study based on 100 UK listed companies which reveal that audit committee meeting frequency and its size having a substantial impact on IC reporting. Building on this line of research, in another study by(Badrul, Khan, & Rahman, 2015)has identified that the presence of audit committee is having a significant positive influence on the IC reporting which based on 135 non- financial companies in Bangladesh. In another recent study (Haji & Haji, 2015), based on leading Malaysian companies for the period 2008-2010 has identified a solid positive influence of the audit committee mechanism on IC reporting.

So here in this study,we look into the influence of audit committee on the reporting of intellectual capital information. The present study argues that audit committee mechanism characteristics will have a significant impact on the excellence of reporting by including more non- financial information, specifically IC information.

So the output of this study would give an understanding about the impact of audit committee mechanism in the board committee, about the role that can impulse the reporting of strategical non-financial information, particularly information on IC.

HYPOTHESES DEVELOPMENT

(Li et al. 2008;Cerbioni and Parbonetti 2007) opine that board structure is an integral part of any corporate governance mechanism, which is vital in forming the firm strategies for IC disclosure. In that, the Audit committee working in between firms management and outside members to reduce the information asymmetry(Rainsbury et al., 2008). Hence, the Audit Committee is considered asa tool to improve the board's function in overseeing the management activities (Peasnell et al., 2005) and equate their interest with shareholders interest. Recent evidence shows that audit committee mechanism of a firm possesses an imperative take in ensuring the disclosure of environmental and social information in corporates reports (Jones & Solomon, 2010), which overlays by intellectual capital reporting (see e.g. Cordazzo, 2005)

Audit committee attributes

Previous research proposes that a well-resourced and independent audit committee's effectiveness will be high while comparing with others (e.g. Mangena & Pike, 2005). Consequently,this study proposed hypotheses regarding on three crucial audit committee characteristicon how it effects reporting of intellectual capital. They are as follows.

Meeting frequency of audit committee (MAC)

The SEBI regulation-2015 has saying that the audit committee of a firm must meet at least 4 times in a financial year. According to Karamanou and Vafeas (2005), to carry out the duty of audit committee proficiently they will have to employ more time. Agrawal and Chadha (2005) say that, by considering complex nature of corporations, it would be very hard for the outsiders who are looking to identify the fraudor accounting malpractices in a very short span of time. Therefore,sufficient time has to be devoted to key issues.(e.g. Raghunandan & Rama, 2007). Numerous studies in literature have been found a significant positive relationship with the frequency of audit committee meetingwith voluntary corporate reporting.(Allegrini & Greco, 2013)(Li, Mangena, & Pike, 2012)(Haji & Haji, 2015). Hence, we assume that:

H1. There is a significant positive connection between the extent of IC reporting and audit committee meeting frequency.

Size of the audit committee (ASIZ)

SEBI regulation, 2015 stated that at least three members has to be there in the audit committee.In the case of an audit committee, should have adequate resource and authority to perform their role moreeffectively, especially after the importance of its role in a firm has elevated(FRC, 2008; Mangena & Pike, 2005,Li et al., 2012).In addition, if the number of members is high, then the audit committee members would expose and solve probable issues in the firms reporting framework, The reason for that, itexpected to impart, the required solid and diverse views and proficiency to ensure exactoverseeing (Bédard et al. 2004). While, many studies are revealed that,size of the audit committee is a significant factor, which determines the quality of firms reporting (Lin et al., 2006; Cornett et al., 2009).In contrast, few prior works find an immaterialeffect on the extent of firmreporting (Bedard et al., 2004; Lary and Taylor, 2012). Thus, empiricallythe evidence is mixed. In contrast,(Li et al., 2012)has found a notable positive relationship among audit committee size on IC disclosure by using evidence from listed firms in the UK. Based on the variedoutcomes, we assume here:

H2. There is no connection among the extent of IC reporting and audit committee size.

Independence of audit committee (ACI)

The SEBI regulation-2015 has saying that two third of the audit committee should consist of directors who are independent. Consequently, Independent directorscan have effective checking on management functioning. This believed notion, make the audit committee independence as more crucial to ensure quality reporting (e.g. Fama & Jensen, 1983). Independent audit committees are out of the management control circle. Hence, they couldsafeguardthe quality and credibility in the reporting process(Mangena and Pike (2005). Thus, it would lead to reduction of theinformation asymmetry. On the experimentalresults side, the evidence is varying. Few prior research found that independence of the audit committee is positively related to the excellence of corporate reporting(e.g. Mangena & Tauringana, 2007; McMullen & Raghunandan, 1996), while, others could not identify a notable association between independence of audit committee with corporate reporting(e.g. Agrawal & Chadha, 2005; Li et al., 2012). The recent study,(Haji & Haji, 2015) who came up with evidence from Malaysian listed companies identified that independence of audit committee and intellectual capital disclosure are related with positive effect. So, on the belief that the independence of audit committee influence positively on corporatereporting, we assume independence of the audit committeewould influence IC reportingin a positive direction. Therefore, we assume that:

H3. There is a positive connection among the extent of IC reporting and the independence of the audit committee.

Control variables

The potential relationship among audit committee attributes and IC disclosure can be influenced by other firm's related elements including size, profitability and governance-related indicators such as independence of the board. Thus, apart from audit committee characteristics, this study used some other variables as control variables such as board independence, firm size, and profitability. The selection of these control variables is purely relied on past literature

RESEARCH DESIGN

Sample

Under this study, the sample was taken as the companies which included in the BSE Sensex index, consisting of 30 companies based on their market capitalization for the financial year 2017-18.In this study, sample has restricted as small intentionally. Because of content analysis, in which we have to spend more time even for a small sample. With this restricted sample, this paper argues that effective audit committee role can contribute firms to reveal more beneficial,non-financial information including IC, especially after the emergence of the knowledge era.

The IC Disclosure Framework

In this study, the IC disclosure practices were captured by using a widely used approach, which called content analysis. According to (Krippendorff, 1980), "content analysis is as a method of codifying the text or content of a piece of writing into various categories. Disclosure studies mostly use content analysis to retrieve disclosures of relevant information in the annual reports."Under this method, a pre-defined disclosure checklist use to check the presence of the information in the annual reports. This study used an IC reporting framework developed by(Mehrotra, Malhotra, & Chauhan, 2016). Theframework was developed in a way that it suited to the Indian environment. The IC reporting framework contains 20 intellectual capital related items, which are categorized as three includinginternal capital(structural capital), external capital(relational capital) and human capital. The detailed IC reporting framework used in this studyinserted in the Appendix section. In the coding process of the disclosure framework, a binary coding that is 0 and 1 has been employed. Value of 0 was given if the item did not exist in the annual report and if it exists then assigned 1.By considering the high chances of subjectivity in content analysis, this paper triedto solve the reliability issue by employing two researchers at the same time for the coding of IC reporting. Later both results were compared and if any difference found, undergone further examination.

variable used for the study

In this section including the model as well as the variable which are used for the study. The data for the study collected from Bloomberg database for the year 2017-18 financial year. Table 1 which deals with the detail of variables used in the study.

Table 1

Dependent and Independent Variable, Source and Measurement

	VARIABLE	OPERATIONALIZATION	SOURCE	ACRONYM
Dependent Variable	IC reporting	20 IC items in the framework are used for coding if the item present put 1, otherwise 0	AR	ICR
Independent Variable	Audit committee size	No. of members in the audit committee	AR	ASIZ
	Audit committee meetings Frequency	No. of audit committee meeting took place during the study period	AR	ACMF
	Independence of Audit committee	As a ratio of no. of independent director in the audit committee for the financial year with the total number of directors at the end of the year in the audit committee	AR	ACI
Control Variables	Independence of board	As a ratioof number of independent directors on the board with a total number of director on the board at the end of the selected year	AR	BI
	Profitability	As a ratio of return and total assets reported in the balance sheet for the particular year	AR	ROA

	Firm size	Revenue generated from sales for the selected year	AR	SS

Note: AR- annual report

EMPIRICAL RESULT

In this section, we looked into descriptive statistics and correlation analyses which are taken to understand the distribution characteristic of the data and to check the issue of multicollinearity. To understand the nature of IC reporting, the study included a summarized table on IC reporting in category wise. Apart from that, to check the relationship between the intellectual capital disclosure and the audit committee attributes for the period 2017-18 we applied multiple regression based on the following model.

$ICR_i = \alpha + \beta_1 (ACI)_i + \beta_2 (ACMF)_i + \beta_3 (ASIZ)_i + \beta_4 (BI)_i + \beta_5 (ROA)_i + \beta_6 (SS)_i + \varepsilon_i$

Table 2

6.1 Descriptive statistics

	ICD	ACI	ACMF	ASIZ	BI	ROA	SS
Mean	0.765385	91.15385	6.730769	3.538462	53.72219	8.276008	5.839995
Median	0.800000	100.0000	6.000000	4.000000	50.00000	4.376400	5.902484
Maximum	0.900000	100.0000	11.00000	7.000000	75.00000	31.06530	6.592928
Minimum	0.500000	75.00000	4.000000	2.000000	33.33300	0.069300	5.220123
Std. Dev.	0.121465	11.51588	1.778937	1.207668	10.15228	8.477435	0.351299

Table 2 shows descriptive results of both depended and independent for the financial year 2017-18, by employing a comprehensive coding procedure using a 0-1 scale to check how the IC information reported in the annual report of selected companies. The ICD rate ranges from 0.50 to .90 with a mean value of 0.76 for the selected period. In the case of independent variable ACI (Audit committee independence) having a value ranges 75 to 100 percent of independent directors on board. In addition frequency of audit committee meeting showing 11 and 4 as their maximum and minimum value with an average meeting of 6.73 apart from that audit committee size has shown value as a maximum of 7 and minimum of 2 with a mean 3.53.

Table 3

IC Disclosure-Category wise

CATEGORY OF IC	% DISCLOSED
Internal Capital Or Structural Capital	87%
External Capital Or Relational Capital	85%
Human Capital	57%

Table 3 shows the result of IC disclosure by categories wise for the particular period. From the above result of the content analysis, it is clear that internal capital and external capital are the top reported category in intellectual capital. In intellectual capital both internal capital(knowledge found within the organization and its process) and external capital(knowledge found on relationship with outside of the firm)While, comparing with human capital which deals with knowledge within people,those are reported with a percentage of 87% and 85% respectively but human capital only 57% which are comparatively less. The next segment examines the effect of audit committee characteristic in ICD by using multiple regression.

Multiple Regression Results

In this section, detail the result of multiple regression which applied on a cross-sectional data collected from selected firm to study the role of audit committee mechanism on intellectual capital reporting. In the first phase of the next section deals with the issue of multicollinearity then subsequently deals with regression results.

Table 4

Correlation Matrix of Independent Variable

	ACI	AF	ASIZ	BI	ROA	SS
ACI	1.000000	-0.052569	0.054205	0.014530	0.053877	0.178449
ACMF	-0.052569	1.000000	0.070179	-0.020506	-0.294015	0.040165

ASIZ	0.054205	0.070179	1.000000	0.551730	0.004813	0.232505
BI	0.014530	-0.020506	0.551730	1.000000	0.047500	-0.001162
ROA	0.053877	-0.294015	0.004813	0.047500	1.000000	0.039101
SS	0.178449	0.040165	0.232505	-0.001162	0.039101	1.000000

Before doing multiple regression analysis, we initially checking whether the problem of multicollinearity among the independent variable is there or not. Correlation matrix has been used to spot the problem of multicollinearity and the high value of correlation between Audit committee size and board independence with a positive figure 0.55 which is lowerthan the suggested value of 0.7, if the value more than that we can suspect multicollinearity concern (Tabachnik and fidell.2001).

Table 5

Multiple Regression Result

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.377733	0.414499	0.911299	0.3736
ACI	-0.003421	0.001906	-1.795292	0.0885*
ACMF	0.031126	0.012747	2.441885	0.0246**
ASIZ	0.012380	0.022368	0.553442	0.5864
BI	0.002009	0.002585	0.777208	0.4466
ROA	0.000997	0.002666	0.373812	0.7127
SS	0.056510	0.064901	0.870710	0.3948
R-squared	0.402470			
Adjusted R-squared	0.213776			
F-statistic	2.132924			
Prob(F-statistic)	0.096847			

Notes:**significant at the 5% level;*significant at the 1% level

Table 5 is showing the regression result of the connectionamong the audit committee mechanism and IC reporting are given. The regression model having an explanatory power of 21.37(Adjusted R^2), which means that by using the proposed model the independent variable can explain 21.37 percentage of IC reporting. More specifically, the result shows that Audit committee frequency (ACMF) is significantly and positively related to the overall IC reporting at the 5% level. Which is in line with previous studies(Li et al., 2012)(Haji & Haji, 2015). So the result indicates that activities of the audit committee is an imperative factor in improving IC reporting which would decrease the information asymmetry about the firm. We observe that independence of the audit committee (ACI) is showing a significant negative association with IC reporting. These result is surprising as well as inconsistent with our prior expectation. So which means once the independence of the audit committee is more, it leads to disclosing of a lesser volume of information on intellectual capital. About the size of the audit committee (ASIZ) as we expected, no notable relationship between audit committee size and IC reporting. So this result is in line with the results ofYang and Krishnan(2005). Though, we could say that this study shows that the size of the audit committee doesn't have any kind of effect on the intellectual capital information reporting. In terms of control variable such as board independence (BI) profitability (ROA) as well as the firm size (SS) shown a relationship as we expected but not significant at all.

CONCLUSION

The audit committee is an important subcommittee of the board functioning to surveillance the corporate reporting process by ensuring its quality. In addition to that assist the board in overseeing the management dealings. Its role considered more crucial after the importance of non-financial information has raised. Since it would lead to an increase in the quality of reporting.Hence, reporting of financial prospects of a firm is not only the role of audit committee, nevertheless, but it also extends to the revealing of non-mandatory information including IC. To the extent that IC information is vital for the valuation of the firm's shares. Hence this studyclaim that audit committee effect firm disclosure which would reflect in the stock market, consequently lead to decrease the information asymmetry related to valueformationabilities of IC assets.Therefore,this paper, we examined the importance of the audit committee in improving the disclosure of IC information in the corporate reports. More specifically, this study looking into the association between Audit committee characteristic and IC reporting.The study identified that AC meeting frequency is positively related to IC reporting. Surprisingly we found a negative relationship between audit committee independence with IC reporting which was against our prior expectation. Later, identified no noteworthy association between sizes of the audit committee with IC reporting. So by considering a whole picture of the result, the study upholds the evidence for a significant impact of audit committee mechanism on Intellectual capital disclosure.The result of the study provides implication especially to policymakers in a way that the importance of the audit committee mechanism can be stretched to confirm the reporting of non-mandatory information in the corporate reports. While coming to the academics, there have widely accepted assumption that the audit committee mean for to detect the problems in the financial reporting. Now, this is the time to broaden student's perspective on the scope of corporate reporting by extending the importance of non- financial information mainly include, social, environmental,IC aspects of a firm. This paper is limited to the characteristic of the audit committee. In that, didn't consider the financial expertise of the audit committee. Apart from that, the study has used two researchers to solve the issue of the subjectivity of content analysis, still, we couldn't say that our coding process is cent percent free from subjectivity. As future research opportunity, they can include other non-mandatory information to know how the audit committee characteristic is impacting on it.

Appendix A. IC Reporting Framework

HUMAN CAPITAL	**INTERNAL CAPITAL(Structural capital)**	**EXTERNAL CAPITAL(Relational capital)**
Education	Intellectual property	Brands
Work related knowledge/Know-how	Information systems	Distribution channels
Training	Management processes	Business collaborations/partnerships
Employee expertise	Management Philosophy/Corporate Culture	Licensing agreements
Employee numbers	Financial relations	Customer satisfaction
Knowledge sharing	Innovation	Customers
Employee safety		Market share

Source:(Mehrotra et al., 2016)

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