

# Intellectual Capital Mediation Effect in Indonesia's Banking Industries

Mutiara Rachma Ardhiani<sup>a</sup>, Mohammad Nasih<sup>b\*</sup>, <sup>a,b</sup>Department of Accountancy, Faculty of Economics and Business, Universitas Airlangga, Email: <sup>b\*</sup>[mohnasih@feb.unair.ac.id](mailto:mohnasih@feb.unair.ac.id)

This study aims to analyze the influence of the mediation of Intellectual Capital (IC) on the influence of Good Corporate Governance (GCG) and financial capital on company performance. This study used a sample of banking companies listed on the Indonesian Stock Exchange (IDX) in 2015 - 2017 with 117 units of observation chosen by the census method. This study found that there is a role of IC mediation in supporting the influence of GCG and financial capital indirectly on a firm's performance. These results prove that IC has an indirect influence on company performance through the management and supervision of companies run by human resources that are competent at the GCG system so then they are able to carry out their functions and roles. Managing the appropriate financial capital can also have a good impact on the company's performance. The results of this study support a resource -based view and knowledge-based view which states that IC is a company resource that comes from knowledge that is able to provide a competitive advantage. The study is unique as the findings shed light on a mixed results debate and used a different proxy for the GCG composite index self-assessment.

**Key words:** *Good Corporate Governance, financial capital, intellectual capital, resource based view, knowledge based view.*

## Introduction

In current economics, as a result of the transition from an economy that relies on the production factor to intellectual assets, certain knowledge, abilities, values, and methods that are not easily imitated have become the main factors in wealth production (Bayraktaroglu et al., 2019; Seetharaman et al., 2002). Intellectual assets, also known as intellectual capital (IC) offer a variety of different organizational values such as increasing the benefits of getting innovation from other companies, retaining customers, reducing costs and increasing productivity (Hariyati et al., 2019). Appropriate intellectual resource management will help the company

achieve its goals (Utama & Mirhard, 2016). Despite their importance, IC is not easily measured as is does not present in the financial statements of the firms (Bontis, 1998; Hunter et al., 2005). This leads to the public searching for the surrogate of IC as a primary resource that is easier to measure such as GCG and financial capital. However, this replacement resource will not have a similar result on a firm's performance.

Increasing research has been conducted in terms of analyzing the correlation of Good Corporate Governance (GCG) and financial capital on a firm's financial performance. Understanding good corporate governance is a form of acceptance in a set of rules or good corporate governance to regulate the relationships, functions and interests of various business parties (Tandean & Winnie, 2016). Using Warsaw listed firms, Kowalewski (2016) found that firms that have a higher GCG value measured by the Corporate Governance Index were shown to experience higher financial performance compared to firms with a lower Corporate Governance Index. Zabri et al. (2016) found empirical evidence that board size as a GCG proxy has a negative correlation with Return on Asset (ROA) in 100 Malaysian listed firms. Another stream of research based on financial capital was conducted by Khizindar and Darley (2017). The authors found that in the Middle-east, financial capital has a positive correlation with financial performance while Erić, Stefanović and Bradić-Martinović (2008) found that debt intensity in one of the financial capital sources has a negative correlation with financial performance. Several other research studies have analyzed the effects of GCG and financial capital on financial performance within a single country, providing mixed evidence (Abdallah & Ismail, 2017; Altuner et al., 2015; Danso & Adomako, 2014; Mishra & Mohanty, 2014; Nkundabanyanga et al., 2014; Nkundabanyanga, 2016; Zaidirina & Lindrianasari, 2015).

The aforementioned research provides evidence on the ongoing debate regarding the benefits of GCG and financial capital as related to financial performance. This research proposed to investigate a variable that creates these mixed results and hypothesizes that it is intellectual capital. The study aims to analyze the influence of the mediation of IC on the correlation between GCG and financial capital on company performance.

To guide hypothesis development and interpretation of the empirical results, path analysis was employed to examine the mediation effect of IC. First, correlation between GCG and financial capital on the firm's performance was tested. Then a mediation model was devised by including IC as the mediation variable in the previous model. Finally, it was concluded the IC capabilities as a mediation variable based on both of the correlation model tests. R-square test results ensure research model robustness. The final sample consisted of 39 Indonesian listed banks from 2015 – 2017. Different to the previous studies, this research employed GCG measurements based on the GCG self-assessment composite index by Bank Indonesia.

The empirical results can be summarized as follows. First, GCG and a firm's performance in the mediation model have no correlation - the other mediators were shown to have a correlation. Based on this result, it was confirmed that IC can fully mediate the correlation between GCG and a firm's performance. Second, IC partially mediates the correlation between financial capital and the firm's performance as the path coefficient was shown to be lowered in the mediation model. Third, this research model's R-square was 0.342 for IC and 0.564 for firm performance, which means the model is robust.

This study provides several contributions both in terms of the literature and in a practical sense. The study results confirm the resource-based view and knowledge-based view that states that IC as a form of knowledge-based capital can provide a competitive advantage. Additionally, this study brings light to the mixed results of GCG and financial capital correlation on a firm's performance. As for the practical side, this study also provides an insight into the industry that is knowledge-based, such as banks needing to give serious considerations to IC level as this can be material to allow for better performance.

The rest of this paper has been organized as follows. Section 2 provides an institutional setting and rationale for the hypothesis development. Section 3 specifies variable operationalization and research methods. Section 4 is an explanation of empirical results and lastly, Section 5 concludes and puts forward the research implications and future research recommendations.

## **Hypothesis Development**

The Resource-Based View (RBV) is a preposition that states that in order to achieve a competitive advantage (some of the literature said exceptional performance), firms must possess and utilize rare resources that their competitors lack (Bashiri & Divangahi, 2013) that leads to value creation and strategic management discipline (Barney, 2000; Wernerfelt, 1984). Later on, RBV became Knowledge-Based View (KBV), which is a preposition that focuses on knowledge resources in any form (Grant, 1996). As one of the knowledge resources, IC urgencies have been increased sharply as KBV has become well-known. This is as IC is basically an output of the knowledge creation process that is known as the base concept of KBV (Bontis, 1998; Maria et al., 2003; Nasih, 2011).

Increasing studies have been conducted to examine the correlation presence of intellectual capital on firm performance. They show positive results (Buallay, 2019; Dabić et al., 2019; Nadeem et al., 2019; Nimtrakoon, 2015; Siswanti & Sukoharsono, 2019). Studies on other resources such as GCG and financial capital have mixed results related to the firm's performance (Abdallah & Ismail, 2017; Altuner et al., 2015; Danso & Adomako, 2014; Mishra & Mohanty, 2014; Nkundabanyanga et al., 2014; Nkundabanyanga, 2016; Zaidirina & Lindrianasari, 2015). Both Kowalewski (2016) and Khizindar and Darley's (2017) studies

found that GCG and financial capital have a positive correlation with firm performance while Zabri et al. (2016) and Erić et al. (2008) documented the opposite result. These research studies raise two research questions: ‘Why do the resources of a firm have different effects on a firm’s performance?’ and ‘What firm characteristics have become an explanation of these mixed results?’

The possibility of IC becoming the best explanation of the correlation of the firm’s resources (e.g. GCG and financial capital) and the firm’s performance shows mixed results. First, as stated in KBV, the knowledge creation process combines a few unique items of knowledge. It is a must in order to achieve a competitive advantage (Fleming, 2001). The knowledge creation process will be a catalyst for the firm’s environment if it supports high IC. It can come in any form such as an individual employee, knowledge, experience, and information (Bontis, 1998; Nkundabanyanga et al., 2014) A firm that have sufficient human capital, structural capital, and customer/relational capital will have better opportunities to achieve exceptional performance results (Buallay, 2019; Dabić et al., 2019; Nadeem et al., 2019; Nimtrakoon, 2015; Siswanti & Sukoharsono, 2019) by guiding resource utilization in which GCG and financial performance will focus on increasing the firm’s performance rather than diminishing it.

Second, GCG is basically a system within firms that spur on the quality of the stakeholder connection (Lakshan & Wijekoon, 2012; Shank et al., 2013) that will directly correlate with IC. This is as IC serves as an output of GCG (Altuner et al., 2015; Nkundabanyanga et al., 2014; Nkundabanyanga, 2016; Ranjith & Buyan, 2015). As for financial capital, Murthy and Mouritsen (2011) imply that financial capital does not just interact but it also becomes an input for IC. In order to increase the value of IC, employee training and development needs substantial capital to fund it. It can be concluded that both GCG and financial capital have a role as an input of IC and the output is firm performance (Abdallah & Ismail, 2017; Altuner et al., 2015; Danso & Adomako, 2014; Mishra & Mohanty, 2014; Nkundabanyanga et al., 2014; Nkundabanyanga, 2016; Zaidirina & Lindrianasari, 2015). This can be an explanation as to why both GCG and financial capital have mixed results on firm performance as there is IC as the mediator for this correlation. From these two explanations, it is hypothesised that:

H<sub>1</sub>: Intellectual capital mediates the correlation of GCG on the firm’s performance

H<sub>2</sub>: Intellectual capital mediates the correlation of financial capital on the firm’s performance

## **Research Methodology**

### ***Sample Selection and Data Source***

The initial sample consisted of 44 Indonesia listed banks between 2015-2017 that created a 132 year-observation. Banks were used as the research sample as according to Bank Indonesia (central bank of Indonesia), all banks that are operationalized in Indonesia should fill in a GCG composite index self-assessment annually. Other industries are not obligated to fill in the same

form<sup>1</sup>. Sharia banks were also excluded as they have different operation details. The final sample was 39 listed banks that created a 117 year-observation.

### ***Variable Operationalization***

This research employed four variables to construct a conceptual framework. The variables list, its measurement method and the sources have been listed in Table 1 below. Different to the previous research, the proxy of GCG in this research used the GCG composite index self-assessment that categorized the quality of GCG into five categories: best, good, normal, bad, and worst. As for the financial capital (FC), the natural logarithm of total equity was employed (Best, 2017; Coleman, 2007; Nasih, 2011). For firm performance (FP), ROA was used as the variable proxy as it reflects the capability of the firm in utilizing the assets that it owns.

The main interested variable, intellectual capital (IC), was measured using the following model that was developed by Pulic (2000). According to Pulic, IC is the culmination of three components, Value Added Capital Employed (VACA), Value Added Human Capital (VAHU), and Value Added Structural Capital (STVA).

$$VACA = \frac{VA}{CE}$$

$$VAHU = \frac{VA}{\frac{HC}{SC}}$$

$$STVA = \frac{VA}{SC}$$

$$VA = OUT - IN$$

Where:

VACA = Value added capital employed

VA = Value added

CE = Capital employed (total equity)

VAHU = Value added human capital

HC = Human capital (total wages and salary expenses)

STVA = Value added structural capital

SC = Structural capital (differences between VA and HC)

OUT = Total revenue of firm

IN = Total costs and expenses, except wages and salary expenses, tax, interest, and depreciation

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<sup>1</sup>According to SE Bank Indonesia No. 15/15/DPNP 2013

**Table 1:** Variable Operationalization

Variable	Proxy	Source
Good Corporate Governance (GCG)	GCG Composite index self-assessment, categorized into 5 which is best (< 1.5), good (1.5 – 2.5), normal (2.5 – 3.5), bad (3.5 – 4.5), and worst (> 4.5)	Annual report
Financial Capital (FC)	Natural logarithm of total equity	Financial report
Intellectual Capital (IC)	VACA + VAHU + STVA	Financial report
Firm's Performance (FP)	Total revenue deflated by total asset	Financial report

### **Testing Hypothesis**

In order to test the research hypothesis, we used path analysis to measure the mediation effect of IC based on the mediation criteria that was developed by Hair et al. (2014). First we devised three regression equations which consisted of FP as dependent without IC, IC as dependent, and FP as dependent with IC.

$$FP = \alpha + \beta_1 GCG + \beta_2 FC + \varepsilon \dots \dots \dots (1)$$

$$IC = \alpha + \beta_1 GCG + \beta_2 FC + \varepsilon \dots \dots \dots$$

(2)

$$FP = \alpha + \beta_1 GCG + \beta_2 FC + \beta_3 IC + \varepsilon \dots \dots \dots (3)$$

Second, we compared the significance level and the coefficient determinants of GCG and FC in Equations 1 and 3 in order to measure the mediation effect of IC. The comparison of the results will make it possible to conclude what type of mediation effect there is from IC on the correlation of GCG and FC on FP.

## **Results and Discussion**

### **Pre-main Results**

The descriptive statistics are provided in Table 2 below and the Pearson correlation in Table 3. It can be concluded that on average, Indonesian listed banks have 2.51 in IC value and they are in the good category of the GCG composite index.

**Table 2:** Descriptive Statistics

	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
<b>GCG</b>	1.00	4.00	2.03	0.45
<b>FC</b>	12.22	19.94	15.55	1.83
<b>IC</b>	-15.04	9.92	2.51	2.34
<b>FP</b>	-0.12	0.04	0.01	0.02

**Table 3:** Pearson Correlation

	<b>GCG</b>	<b>FC</b>	<b>IC</b>	<b>FP</b>
<b>GCG</b>	1.000			
<b>FC</b>	0.383	1.000		
<b>IC</b>	0.444	0.522	1.000	
<b>FP</b>	0.395	0.513	0.733	1.000

The regression results without IC as the mediation variable are provided in Table 4 below which shows that both GCG and FC have a positive correlation on FP. This confirms some of the studies that have implied that the better implication of GCG will lead to better firm performance. In order to achieve exceptional performance, the needs of sufficient financial capital cannot be underestimated.

**Table 4:** Path Coefficient Analysis Result Excluding IC as the Mediation Variable

	<b>Original sample estimation</b>	<b>Path coefficient</b>	<b>Standard deviation</b>	<b>T-statistic*</b>
<b>GCG → FP</b>	0.233	0.225	0.068	3.415*
<b>FC → FP</b>	0.424	0.423	0.063	6.751*

\*t > 1.96 on significance level 5%

## Main Results

In Table 5 below, the results of the path coefficient analysis are provided which include IC as the mediation variable. The correlation of GCG on FP is insignificant, as both GCG on IC and IC on FP are positive. This indicates that IC in correlation GCG on FP has a full mediation effect as it is from before including IC (Table 4). GCG on FP has a positive correlation while after including IC (Table 5), it shows an insignificant correlation.

As for the correlation, FC on FP in both regression models (excluding IC and including IC) has shown a similar result. The path component of the correlation of FC on FP is that FC on IC and IC on FP (Table 5) both show there to be a positive correlation. If we take closer look, the path coefficient of FC on FP after including IC (0.175) drastically decreases compared to the path



coefficient before including IC (0.424). According to Hair et al. (2010:746), this result indicates that IC partially mediates the correlation of FC on FP.

**Table 5:** Path Coefficient Analysis Result Including IC as a Mediation Variable

	<b>Original sample estimation</b>	<b>Path coefficient</b>	<b>Standard deviation</b>	<b>T-statistic*</b>
<b>GCG → IC</b>	0.286	0.297	0.048	5.992*
<b>FC → IC</b>	0.412	0.420	0.060	6.853*
<b>GCG → FP</b>	0.055	0.059	0.053	1.036
<b>FC → FP</b>	0.168	0.175	0.050	3.349*
<b>IC → FP</b>	0.622	0.618	0.053	6.751*

\*t > 1.96 on significance level 5%

## Discussion

Basically GCG is a system that has been constructed in order to ensure that the firm is operational, as it is intended to be. GCG will foster the human capital development, innovation, culture, external structure and internal structure that is oriented on the achievement of vision and the mission of the corporation. Good GCG will need the contribution of all related parties within a firm (Lukviarman, 2016; Venkat, 2018). This will create every aspect of IC that can be developed by high quality GCG. Implementing good GCG will provide better opportunities for a firm's IC to be well developed. Lastly, the high quality of IC will result in a higher firm's performance as implied by KBV. This is as other competitors do not possess similar or higher knowledge to allow them to operate more efficient and effectively. This rationale makes IC become a part of the full mediation of correlation in GCG in the firm's performance.

A firm's financial capital amount will indirectly correlate with the firm's performance via IC. A large sum of financial capital will surely speed up the process of IC development as in order to have high qualified IC, a firm must spend a substantial amount of funds to upgrade its IC. It is obvious that sufficient financial capital will allow a firm to access better training and development for the sake of its IC. Similar to the indirect correlation of GCG on FP, in this type of correlation, IC will boost the firm's performance. As a result, the IC partially mediates the correlation of the financial capital and the firm's performance. The partial mediation can come from fact that financial capital has an indirect correlation with the firm's performance which can be via another variable that has not been examined in this research model.





### ***Robustness Test***

To ensure the robustness of the model, R-square test model was employed to empirically determine the quality of the predicting research model. R-square test results showed that the coefficient determinant of IC is 34.2 percent and FP is 56.2 percent. This is considered to be high for a social science research model. The conclusion is that the research model used is reliable and robust from the coefficient determinant perspective.

### **Conclusion**

In summary, this research documents the empirical evidence that intellectual capital mediates the correlation of GCG and financial capital in a firm's performance. This result can imply that without substantial knowledge, the good implementation of GCG and a large sum of financial capital doesn't provide certainty that related firms will have high performance. Rather, IC needs to fully implement the benefits of GCG and financial capital for the firm's performance.

This study provides several contributions both in the literature and in a practical sense. This study result confirms the resource-based view and knowledge-based view that state IC as being knowledge-based capital that provides a competitive advantage. Additionally, this study sheds light on the mixed results of GCG and financial capital correlation on the firm's performance. As for the practical side, this study also provides knowledge-based insights to the industry for example that banks need to give serious consideration to IC level as it can be instrumental to facilitate better performance.

As for future research, it is recommended that a larger sample size from various industries be sourced. This data could then provide a deeper understanding of how IC can mediate in all industries. Another suggestion is to add additional proxies for the firm's performance based on the market reaction such as Tobins' q to ensure that the market has a similar view as the firm's performance based on the firm's operationalization.

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