THE INFLUENCE OF INTELLECTUAL CAPITAL TOWARDS CORPORATE GOVERNANCE PRACTICES IN TOP 100 ASEAN COMPANIES

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ABSTRACT

The purpose of this study is to examine the influence of intellectual capital (IC) towards corporate governance (CG) practices in top 100 ASEAN companies. IC consists of human capital (HC), structural capital (SC) and relational capital (RC). Meanwhile, CG practices were comprised of four aspects that are disclosure, board composition and functioning, ownership and control structure shareholder’s rights. The IC and IC components were computed using the Pulic’s Value Added Intellectual Capital (VAIC) approach while the CG practices of a company was measured based on CG index. 86 out of Top 100 ASEAN companies were used as samples. This study used the secondary data approach in gathering the data. The financial and non-financial data were extracted from the companies’ annual reports for the financial year 2014. Pearson correlation was employed to examine the relationship between IC and IC components with CG practices. Findings indicate that only IC in total and HC component were found to be positively associated to the CG practices in Top 100 ASEAN companies. However, there was no significant relationship between SC and RC with CG practices. Meanwhile, country-by-country analyses show that only HC component has significant relationship with CG practices in Philippine companies. The findings from this study would be useful for companies to relook at their practices and consider the influence of IC in their CG practices. Moreover, the relevant authorities such as the Malaysian Institute of Corporate Governance (MICG), the Securities Commission (SC) and Bursa Malaysia may use the findings to come up with relevant policies in enhancing CG practices and cultures in Malaysia. As for the companies in ASEAN region, they may also taking IC influence seriously in enhancing their CG practices.

Keywords: Intellectual Capital, Corporate Governance, ASEAN

1.0 INTRODUCTION

The 1997 financial crisis that hit the East Asian countries had sparked the greater concern on the corporate governance (CG). As indicated by the World Bank (1998), the main indicator for the Asian financial crisis was due to poor CG. International institutional investors also regarded weak CG provides in inadequate financial disclosure and lack of corporate transparency as a cause of the Asian financial crisis (Tripathi, 1998). Malaysian business environment was also not spared with the development. The increasing number of crisis and business failures of the public listed companies in Malaysia had caused the government to realize that enhancing CG should be an essential agenda to bring back the economy on the right track (Abdul Rahman, 2006).

The Minority Shareholder Watchdog Group (MSWG) has highlighted again the result of CG performance of 2013 in six ASEAN countries which are Malaysia (71.69%), Singapore (71.68%), Thailand (75.39%), Philippines (57.99%), Indonesia (54.55%) and Vietnam (33.87%) (MSWG, 2015). This indicate that the imbalance of CG performance level among the ASEAN countries. There is a big gap of 37.82% between the highest score country which is 71.69% (Malaysia) and the lowest country which is 33.87% (Vietnam). According to Divya Padmanabhan (2011), the reason for such differences might be due to culture or social and constructing legal and financial institutional structural between ASEAN countries. Thus, improving CG practices still a need for some ASEAN countries such as Philippines, Indonesia, and Vietnam.

2.0 RESEARCH BACKGROUND

The Enron debacles that took place in the year 2000 have changed the business landscape tremendously. In addition, the globalization of the markets, heighten competition, technological advancement and increase in unexpected business failures have been the predominant reasons for the growing interests in CG (Abdul Rahman, 2006). CG has long been a hot issue for management, investors and scholars; especially after the corporate scandals of the Enron, World com and Halliburton to mention a few. It has now been established that CG is a very important issue for companies, investors, and even governments and has aroused interest and awareness globally (Man and Kong, 2011).

CG has succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of companies and society in general (Abdul Rahman, 2006). Effective CG systems are crucial for the stability and market-oriented economies. But what are the components that make up good, effective CG of a company? According to the Institute of Internal Auditors (IIA), there are four cornerstones of CG, namely the internal auditors, external auditors, board of directors, and the executive management (IIA, 2012).
Furthermore, according to Barry (2008), “Good governance cannot be imposed; it must emerge from a changed social culture, taken down to the level of the company by capable and committed directors and executives. Therefore, for a governance to win through there should be an effective and collaborative working relationship between board of director and shareholders (Neculai and Mihaela, 2012). The objective of CG is to ensure a balance between the various actors and to implement power control instruments, as it will have major impacts on the performance.

A study by McKinsey and Company (2002) revealed that majority of investors are prepared to pay a premium for companies with higher CG standards; consequently, the CG rankings of companies are also one of the considerations of investors when evaluating stock prices (Berthelot, Morris and Morrill, 2010). In the context of CG, board of directors is the shareholder’s first line of defense. Board members are the individuals that shareholders rely on to ensure that their investment is protected and well managed (Brennan, 2010). This makes the board of directors as one of the most critical internal CG mechanisms.

The players of CG discussed above such as investors, directors, and management are conspicuously related to the IC component based on definition IC by Stewart (1997). However, there are only a few researchers conducted studies to investigate the relationship between IC and CG. Therefore, this study aim to examine the influence or contributions of IC towards CG practices in the top ASEAN companies.

3.0 LITERATURE REVIEW

This section presents a brief analysis of related literature reviews. These reviews provide a clear and concise explanation in order to deliver a better understanding on the purpose of undertaking this study.

3.1 Overview of Corporate Governance Practices

The term ‘Corporate Governance’ (CG) emerged in the 1970s at United States and rapidly become the issue in company within 25 years (Cheffins, 2013). The increasing corporate scandal cases had promoted the development and refinement of CG practices (Kirkpatrick, 2009). CG is the study of distributions of rights, duties and responsibilities among different level of participants in the corporation. Generally, it was believed that a good CG performance in the company can mitigate the wastages, corruption, risks and mismanagement, maintains the confidence of investors to raise capital and also provides accountability to the shareholders that safeguard their interest (Shahid, 2009).

According to Goergen and Renneboog (2006), CG code works as the mechanisms that enable the agent, which is management of the company, to fulfill the benefits of the principals such as shareholders. This aligns with the agency theory where CG was originally developed based on the perspective of relationship between principals and agents. Jensen and Meckling (1976) stated that this agency relationship is a contract under which another party to perform some services on their behalf. The agents refer to employees while the principals refer to shareholders (Eisenhardt, 1989). The employees are closely related with the company’s intellectual capital (IC) since one of the IC components, human capital (HC) is defined as knowledge, skill, talent and experience owned by the employees (Steward, 1997).

Stewart (1997) stated that a success of company is fundamentally based on the skills and knowledge of the workforce, their abilities in solving business problem which can turn company’s performance as well as strong internal control. IC is a company’s intangible assets, it can be either knowledge, information, experience owned by human resources and company’s structure and system (Stewart, 1997). Besides, the relation with shareholders and stakeholders can also effectively improve the company’s competitiveness (Bharadwaj, 2000; Nold III, 2012).

Past researchers discovered that IC is a dominating resource in the contemporary knowledge-based economy, and it is far more important compared to other production factors (Quinn, James, Anderson and Finkelstein, 1996). It was supported by the finding of Abidin (2000) that the inclusion of IC concept generate value to the corporation. Tseng and Lin (2011) have proven that CG has a positive influence to the IC development. They suggest company to employ the CG system adequately in order to use the IC for creating value.

Organisation for Economic Co-operation and Development (OECD) (2004) defines CG as “a set of relationships between a company’s management, its board, its shareholders and other stakeholders. CG also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined that should be promoted. Good CG drives the Board and management to company goal and shareholders interest as well as facilitate effective monitoring. CG also is the mechanism to balance the control and the ownership in the company and facilitate the maximization of company value (Cuervo, 2002). Based on these conventional CG definitions, CG is acknowledged as one or the essential matter that harmonize the relationship of the shareholders, stakeholders and management to lead the sustainability of company.

The OECD Principles has divided the CG into five elements, which are rights of shareholders, equitable treatment of shareholders, roles of stakeholders in CG, disclosure and transparency, and responsibility of Broad (OECD, 1999). These five elements are the guidelines to facilitate the company to increase their CG performance and achieve a better internal management system. Besides that, this principle also intended to facilitate improvement of CG practices and evaluation of CG performance of the company. The CG scorecard had been established based on these five elements in order to measure the CG performance.
From the current CG system that developed by OECD and other CG authorities, this study aims to explore the influence or contributions of IC towards improving CG practices in the top companies in ASEAN countries.

3.2 Overview of Intellectual Capital (IC)

IC is a combination of intangible assets that enable the company to operate (Brookings, 1997). Meanwhile, Roos, Edvinsson and Dragonetti (1997) claimed that IC is the hidden assets include of what is in the heads of the employees and what is left for the company they when they resign, that unable to be fully captured on the balance sheet of the company. IC is intangible assets that consist of skills and knowledge that developed by the company to create competitive advantages (Galbraith 1969). Stewart (1997) defined IC as knowledge, experience, information and intellectual property that enable the company to generate wealth. IC was further described by Dzinkowski (2000) as knowledge-based resources of a company.

According to Stewart (1997), most of the time, IC can be categorized into three components, which are human capital (HC), structural capital (SC) and relational capital (RC). Sveiby (1997) reclassified the SC as internal structure, RC as external structure and HC as personal competencies. The HC includes employees’ knowledge, skills, experience, commitment, capabilities and talents (Bontis, 1996; Yang, Li and Yang, 2007). SC refers to system, culture, structure and operation process, database, strategy and trademark that related to organizational knowledge (Stewart, 1997). RC is the relationship of the company and the stakeholders that are customers, suppliers, lenders and government (Bontis, 1998).

There are a lot of research have been done to prove that IC has some positive impacts to the performance of the company in terms of financial results. Chen, Cheng and Hwang (2005) found that IC has a positive impact on market value and financial performance. These findings have been supported by recent study of Nuhuyana, Irianto and Purnomosidhi (2016) with a positive significant result between IC and company performance. Those studies not only contribute to the literature but also encourage the company to invest in the development and management of IC. Unlike many other previous studies, this study will continually focus on the exploration of the benefits of IC from the CG practices; rather than directly to the company financial performance but more towards the internal management of the company.

3.3 Development of Corporate Government in ASEAN Countries

Asian Financial Crisis in 1997 was a wake-up call for Asian policy makers that include ASEAN companies. This incident has revealed the weaknesses of institutional and policies subsequently spurred multiple reforms. There were many improvements done on CG rules and practices in Asian by OECD and other authorities such as establishment of the OECD-Asian Roundtable on Corporate Governance in 1999 due to this crisis. All of these foster the CG practices in ASEAN countries and strengthen company governance system.

OECD Principles of CG has become the benchmark for the all economies to develop their regulations, CG codes, listing rules, scorecards, as well as academic work. In 2013, the first ASEAN Corporate Governance Scorecard was published based on the guidance of OECD Principles, to unify some of the previously separate national scorecards. The Scorecard is part of a broader agenda for ASEAN regional capital market integration under the ASEAN Capital Markets Forum (ACMF). The report evaluated the CG performance of the top 100 listed companies in Malaysia, Philippines, Indonesia, Thailand, and Singapore and 39 companies in Vietnam.

3.4 Relationship of Intellectual Capital and Corporate Governance

Keenan and Aggestam (2001) explained that there are benefits to be derived by company through linkages between CG and IC. Furthermore, the IC exists in the company regardless the recognition of IC by the board and CG system. They also concluded that both CG and IC are focus on value creation and stakeholders’ interest. Besides, a positive relationship was found between gender, race and duality chairman with IC performance (Ho and Williams 2003). This was supported by the study conducted by Swartz and Firer (2005) that the racial diversity had a positive relationship to IC performance. The IC and CG were significantly related to each other (Tseng and Lin, 2015).

According to above definition, CG can be defined as the key to lead the company to success or failure on the aspect of management and it comes from the implementation of the CG codes. Thus, the company must invest, accumulate, establish the CG system, which in charge by a knowledge based system. While the knowledge based system refers to the quality of IC that exist internally, externally even personally of the company; that is controllable by the company.

These IC and CG relationships elicit the motive of this study to explore the impact of IC to CG practices. Besides that, it also aims to discover the power of knowledge influence the achievement of the CG in a company. However, the CG involves various areas such as behavior of manager, ownership structure and company performance. Therefore, this study will adapt the CG index that developed by Carvalhal da Silva & Pereira Camara Leal (2005) to measure the CG practices.

3.5 CG Index

This study employed CG Index in measuring the CG practices in the top ASEAN companies. The CG Index adapted from prior study such as Carvalhal da Silva and Pereira Camara Leal (2005) and Amanuddin et al. (2016). Besides, the study also referred to the Guiding Reference provided by the MSWG 2015. The CG Index that used in this study is based on CG index questions which consist of four elements of CG. The four elements include disclosure, board composition and functioning, ownership and
control structure shareholder’s rights (Carvalhal da Silva and Pereira Camara Leal, 2005). In this study, some of the CG index questions are modified due to the limitation of available information, by referring the guiding reference of MSWG (2015).

In the OECD report (2015), it stated that “the CG framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company”. There are a few type of disclosures which are mandatory that required by authorities and some voluntary disclosures. The level of accuracy and transparency of the information highly affects all the shareholders as well as stakeholders.

Board structures and procedures are charging the functions of governing the company and monitoring management. The Board must have objective and independent judgement for monitoring managerial performance and achieving an adequate profit, at the same time prevent the conflict of interest with the shareholders. The Board also has a duty to take care the interest of other stakeholders such as employees, creditors, customers, suppliers and local communities (OECD, 2015).

The ownership structure is defined as the owners have a right over of property by distribution of equity in the company. Ownership structure may determine the incentives of managers and set the economic efficiency of the company. Berle and Means (1932) stated that conflicts of interest between controllers and managers and concluded that with increasing ownership diffusion, the authority of the shareholders to control management is minimized. There are a lot of past research studied on the impact of ownership structure towards company performance. For example, Mehran (1995) found a positive relationship between ownership and the company performance.

3.6 Relevant Theories

This part will review the theories that support this research. The related theories for this study are agency theory and stakeholder theory.

**Agency Theory**

Agency problem occurred because there is separation between ownership and principal which both parties had different interests. Jensen and Meckling (1976) describe agency theory as a relationship between the principal and agent to perform some services on their behalf that involves a decision-making authority to the agent. Based on the past researcher, agency problem can be reduce when there is implementation of CG system which companies are directed, controlled and monitored (Hua and Mat Zin 2007). According to Rahman, Ibrahim and Ahmad (2015), the agency theory posits that management, as an agent of the shareholders has to protect shareholders’ interests by maximizing their wealth. However, the management had their own opportunistic behavior in accessing companies’ resources to serve their own interests rather than shareholders’. This is why the board has a responsibility to monitor the activities of manager.

**Stakeholder Theory**

The manager of the company should fulfill stakeholder management where the manager has to manage the corporation for the benefits of its stakeholders in order to ensure their rights and the participation in decision-making and act as stakeholder’s agent to ensure the survival of the company (Fontaine, Haarman and Schmid, 2006). Based on the past researcher, stakeholders may bring action against the directors for failure to perform the required duty of care (Freeman, 2004). Stakeholder is a person or group that can be affected by the action of a business. It comprise with employees, customers, suppliers, creditors and even the wider of community and competitors. With regard to CG stakeholder is an approach to the conventional shareholder-wealth maximizing companies. There is argument that the theory is narrow because it identifies shareholder as the only interest group of the entity, however, the stakeholder theory is better in explaining the role of CG than the agency theory by highlighting different electors of a company (Coleman, 2008: 4).

3.7 Theoretical Framework

Based on the literature review and theories discussed above, this study comes up with the following theoretical framework. The Theoretical Framework for this study is illustrated in Figure 1.

**Figure 1: Theoretical Framework**
Independent Variables
- Intellectual Capital
  - Human Capital
  - Structural Capital
  - Relational Capital

Dependent Variable
- Corporate Governance
  - CG Index

4.0 RESEARCH METHODOLOGY

The target population for this research was the Top 100 listed companies by market capitalization published by the Nikkei Asian Review magazine in November 2014 for ASEAN countries. However, the available samples were only 86 companies that come from six countries - Malaysia, Singapore, Indonesia, Thailand, Vietnam and Philippines. Companies from other ASEAN countries such as Brunei, Cambodia, Laos and Myanmar were not part of the samples since they were not included in the Top 100 ASEAN companies. There are a few reasons why those countries were not part of the sample; for example, countries like Myanmar and Laos are still facing the diverse challenges in their countries such as lack of regulatory framework, lack of fiscal resources, accessibility and others. Moreover, some of these companies have no data to represent on CG practices in their company, the outlined data and the difficulties on accessing the information. Furthermore, Vietnam was excluded in this study, as there is only one Vietnam Company on the list of Top 100 ASEAN companies. Thus, it is unable to represent Vietnam and provide relevant view.

This study used the secondary source of data from the samples selected. The data were collected via company’s annual reports in which most of the information needed for the study are available. The reason for adopting this method of data collection is because the listed companies’ annual reports are the audited information that published to the public and hence it is easily accessible sources of information. Annual reports of Financial Year 2015 was used to collect the required data for the companies under study. By choosing these samples, data collection process was easier because the information attached by these companies is complete and organized after excluding the companies that have missing data. This ensured the accuracy of data collected for independent and dependent variables.

The data from companies’ annual reports was collected based on the information needed in this study. Those data collected was used for the measurements of IC and CG practices. According to Rimmel (2011), annual reports are considered as the main tool of communication and it provides a general picture of a company.

Measurement of Variables

The main purpose of the study is to determine whether the influence of IC can give impacts towards CG practices for the Top 100 companies in ASEAN countries. There are mainly two types of variables that would be observed in this study which are dependent variable (DV) and independent variables (IV).

CG Index is used as the dependent variable for this study. CG Index are used for measuring the CG practices. The CG Index questions are based on four elements, which are the disclosures, board composition and functioning, ownership and control structure, and shareholder’s rights. Based on these elements, the CG practices can be determined by the average score of the CG Index of the company. As for the independent variables, IC and its components were used in this study. The measurement of IC is using Value Added Intellectual Capital (VAIC) method or known as Value Creation Efficiency Analysis developed by Pulic (2000). VAIC is based on the real value and performance of a company that predicts the future abilities to more objectively. VAIC is using the Value Added (VA) measurement in determining the IC efficiencies in a company. The VA is measured by differentiating the sales (OUT) and inputs (IN). The formula of VA is:

\[ VA = OP + EC + D + A \]

Where, OP=Operating Profit, EC=Employees cost; D=Depreciation, A=Amortization

5.0 FINDINGS AND DISCUSSION

The correlation analysis is used to determine the association and the strength of the association found between two or more variables. This study employed the Pearson Correlation to analyse the relationship between the independent variables (IC and IC
components - HC, SC, and RC) and dependent variable (CG) in the Top 100 ASEAN companies and from the individual country perspective. Cohen’s rule of thumb is applied to explain the magnitude of the relationship (Cohen, 1998):

<table>
<thead>
<tr>
<th>Strength of Relationship</th>
<th>Correlation Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>0.50-0.10</td>
</tr>
<tr>
<td>Medium</td>
<td>0.30-0.49</td>
</tr>
<tr>
<td>Small</td>
<td>0.01-0.29</td>
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</table>

5.1 Correlation Analysis of Top 100 ASEAN Companies

Table 2 presents the results of the correlation analyses of three components of IC and IC with CG practices for Top 100 ASEAN companies.

<table>
<thead>
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<th>Table 2: Correlation Analysis of Top 100 ASEAN Companies</th>
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<tr>
<td>p-value</td>
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<tr>
<td>---------</td>
</tr>
<tr>
<td>Human Capital</td>
</tr>
<tr>
<td>Structural Capital</td>
</tr>
<tr>
<td>Relational Capital</td>
</tr>
<tr>
<td>Intellectual Capital</td>
</tr>
</tbody>
</table>

* Correlation is significant at the 0.05 level (2-tailed).

Based on the results displayed in Table 2, the p-value of IC is 0.022 (p-value< 0.05) which indicated a positive significant relationship of IC with CG practices in Top 100 ASEAN companies. However, the magnitude of this relationship is small as the correlation coefficient value was only 0.244 (Cohen, 1998). It means that as the company employed more IC, the CG practices in that company would be higher. This result was in contrast with the finding of Al-Misally and Ismail (2012) that IC performance is not significantly associated with CG in listed banks in Gulf Cooperation Council (GCC) countries, which encompass Bahrain, Saudi Arabia, Qatar, Kuwait, Oman and the United Arab Emirates.

From the IC component analyses, the p-value of HC of Top 100 ASEAN companies is 0.023 which is smaller than 0.05 as stated in Table 2. This indicated a positive significant relationship between HC and CG practices in Top 100 ASEAN companies. This means that HC is an important aspect in order to boost up the company CG practices. According to Cohen (1998), the strength of the relationship between HC and CG practices in Top 100 ASEAN companies is small since the correlation coefficient is only 0.244. Results shown in Table 2 also indicate that there is no significant relationship found between SC and RC with CG practices in Top 100 ASEAN companies as the p-value is greater than 0.05.

5.2 Correlation Analysis by Countries

Table 3 illustrates the analysis of correlation between three components of IC and IC with CG practices of companies for all countries under study - Indonesia, Malaysia, Philippines, Singapore and Thailand.

<table>
<thead>
<tr>
<th>Table 3: Correlation Analysis by Countries</th>
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<tbody>
<tr>
<td>Indonesia</td>
</tr>
<tr>
<td>p-value</td>
</tr>
<tr>
<td>HC</td>
</tr>
<tr>
<td>SC</td>
</tr>
<tr>
<td>RC</td>
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<tr>
<td>IC</td>
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</table>

Country by country analysis indicated that only HC of Philippines companies has positive significant relationship with CG practices as the p-value is 0.031 (p-value < 0.05). According to Cohen (1998), since the correlation coefficient was 0.649, the relationship is considered large. This result was supported by the study of Tseng and Lin (2011) for the infrastructure companies in Taiwan, where the CG has a positive significant relationship with HC. However, for other ASEAN countries (Indonesia, Malaysia, Singapore, and, Thailand), HC is not significantly related with their company CG practices since the p-value > 0.05.

RC and SC do not have any relationship with CG practices for individual countries settings. These were because all the p-value is greater than 0.05 as presented in Table 3. The results were consistent with parts of the finding of Tseng and Lin (2011) who found a positive significant association between SC and RC with CG. The possible factor that caused this different may be due to the different CG measurement used in both studies. Tseng and Lin (2011) used the CG characteristics to determine the CG of Taiwanese infrastructure companies such as board size, chairman duality, directors’ education level and other characteristics.

Study on impacts of IC components (HC, SC and RC) towards company performance also one of the favorable topic for researchers as compared to study on IC components and CG. One of them is Nimtrakoon (2015) who examined the relationship of IC components with companies’ market value and financial performance in ASEAN countries consisting of Indonesia, Malaysia, Philippines, Singapore and Thailand. In Nimtrakoon’s study, HC was found to be one of the IC components that most influential the companies’ market value and financial performance as compared to SC and RC.
6.0 SIGNIFICANCE OF THE STUDY

The results of the study is hoped to provide some input and bring about new perspectives on the CG practices to relevant authorities such as the Minority Shareholder Watchdog Group (MSWG), Organization of Economic Cooperation and Development (OECD), ASEAN Capital Market Forum (ACMF), Malaysian Institute of Corporate Governance (MICG) and others. These authorities would be able to relook at the CG Codes and practices of the companies in Malaysia or other ASEAN countries. The relevant parties involved should be encouraged to put on more efforts and resources to develop a better quality of IC in the company management in endeavors to enhance a better governance practices. It is also envisaged to assist companies that are involved in CG development and practices to a greater level.

Furthermore, the findings from this research also may provide an alternative way for the management to improve their current CG performance level by investing in right components of IC, either human capital, structural capital or relational capital. Besides implementing the CG Code that issued by authorities, findings from this study shall also provide guidance to companies to prioritize the right components of IC for achieving a better CG results.

Ultimately, with proper governance, the companies’ performance will improve and hence be able to attract more investors to Malaysian capital market. Lastly, it is hoped that this study will also contribute in helping a company to evaluate and improve other governance processes via promulgating the intellectual capital management effectively.

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