

## **Intellectual Capital Effects by Satisfactory Design on Financial and Economic Performance of Malaysian Companies**

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### **Abstract**

This paper aims to prepare intellectual capital component by satisfactory design. Satisfaction of employees, customers and residual benefit are the main core of present measurements. The correct position of these items in the financial statements are proposed by correcting entries, then the impact of these elements are investigated on the return on equity, revenue growth and economic value added. Both disproportionate stratified random sampling and systematic omission have been applied to achieve this study to eight industries and finally thirty six companies from the main board of Malaysian stock exchange during the years, 2006-2013. Firm size and debt ratio are used as control variables. Obtained output demonstrate that, all components have positive effect on ROE just human and structural capital have negative relationship with revenue growth and EVA, respectively. This matter reveals that, that it is not just payment to employees, but the payment structure is also important and negative relationship between SC and EVA proved that, by increase of firms income the motivation of dividend income will increase and the economic value of firms will reduced.

**Keywords:** EVA, Intellectual Capital, Residual Benefit, RG, ROE, Satisfaction

## 1. Introduction

In the age of information, there is a deep gap between the market value and book value of assets. This means that, in the current era, organizations are not able to measure their assets accurately perfect. In other words, some assets are not recognized in the financial statements. Most entities are reported those assets that have objectivity. Valuation of the firms in this era is much more difficult than in the past, since the proportion of intangibles are increasing in the firms. The years 2008-2011 concentrates on intangible capital formation in Europe. Europe to become the most competitive and dynamic knowledge driven economy by 2010. The Coca Cola brand is worth more than half of the market value, and it is evaluated 10 times over the parent company's book value, while the value of the Microsoft brand is about twenty percent of the firm's market value and over 1.5 times of its book value (Kohli & Leuthesser, 2013).

Despite of the confusion on what intellectual capital (IC) means, in this study, given the functional definition, IC are part of intangibles, they are intangible features of items that are typically existed in the financial statements but their position is not consistent with their function, not meet the recognition criteria of assets, although bring future benefits for the company. They are said to be the intellectual as in them lies the essence of satisfaction, creativity or thought and create huge values for the firms. They are said to be the capital, since their capitalization in new accounting environment are needed. Most researchers believe that intellectual capital covers three constructs, which are human capital (HC), structural capital (SC) and relational capital (RC).

The primary objective of this study attempts to measure the intellectual capital and its components by a new approach that contribute to the transparency of accounting information. This measurement are based on the satisfaction of personals, needs of customers and residual earning from firms' infrastructures as the proxy of human, customer and structural capital, respectively and prepare the correct

position for these items in the balance sheet. It is examined the effects of intellectual capital for the firms. This research have also wants to determine empirically the components of intellectual capital effects on the financial, economic profitability and growth of revenue (sale) of publicly listed companies in main board of Malaysian stock exchange in the period between the years 2006-2013.

## 2. LITERATURE REVIEW

In the late 1980s academics and practitioners started to raise their concerns about this practice and argued that if accounting rules would not adapt to the increasing need to provide relevant information about investments in IC, accounting will loosen its relevance (Johnson and Kaplan, 1987). In fact, R&D investments in the US economy doubled for the period of 1953-1997, while investment in tangible properties remained steady. Even with this increase in investments in IC as future sources of value and income, most of them have to be immediately expensed, thus decreasing current income and book value of equity. The concerns about the decreasing relevance of traditional accounting information quickly surpassed the United State of America.

In the accounting study the term of intangible assets, is more generally used and refers, to the non-physical value drivers in organizations that represent claims to future benefits. In an industrial economy production facility, physical location, and efficient manufacturing processes were the vital resources for a firm and sufficient to sustain a superior position in the market place (Nakamura, 2001). Organization have always relied the new idea and knowledge of their employers (Marr and Spender, 2004). In such a world, traditional cost-focused reporting methods were able to provide an adequate picture of firm performance. However, global trade has changed gradually this towards buyers' markets. Such markets do not absorb all goods produced when they are saturated. Consumers are informed more and are demanding more, which leads to increasing innovation speed and decreasing product life

cycles. Innovation and differentiation become critical and capabilities and assets such as R&D, creativity, brand image, patents and copyrights are essential to achieving a competitive advantage. This also means that traditional cost concentrate on reporting tools and cannot provide the adequate information of firm performance.

Intellectual capital comprises a subset of intangible assets, which is adopted in this study. Intangible assets and intellectual capital will be used interchangeably with the view that intellectual capital is part of the intangible assets of a company (Hunter & Elizabeth, 2005). The literature lacks a clear measurement for HC, by education and training and other compensating payments have long been used as proxies of HC measurements (Cohen & Soto, 2007). This novel measurement of HC, which was well known as Innovative Human Capital, includes either traditional or tangible and the more intangible elements, such as satisfaction of job and tendency to change. It is important for firms and policy makers to identify the competitive advantage attained by innovative action of employee's characteristics as a valuable resource to develop.

Satisfaction of employees, also called jobs satisfaction (Wang, 2005). It has defined as feelings of employees and their thought about firm. The theory of value has developed by (Locke, 1976) and states that satisfaction of employees does not meet individual desires, but it relates to needs and demands of employees. In case of a good salary payments, other bonus or compensations in the future, may positively have impact on the loyalty of employees and ultimately grow the job satisfaction. Happy employees are better able to attract customers and the employee's unsatisfied personal of job can cause customer dissatisfaction (Kamal & Hanif, 2009). Investigated the relationship between job satisfactions and environmental and demographic factors and found that environmental factors like, salary, promotion and supervision are best predictors of job satisfaction especially when compared to demographic factors like age, sex and level of education as well as other factors related to

their experience of job, like job position or level or shift work (Abdulla & Djebavni, 2009).

In this era, through competition a company needs to communicate the benefits of its production to potential and current customers. Marketing communication also concentrates on the preparing effectively the organizational messages, as correctly designed messages have impact on the behavior of the consumers, which leads to the improve of sales (Abhijit, 2012). Marketing represents the voice of the firm and its brand, and is a tool by which it can develop a dialogue and build relationships with consumers or consumer (Odunlami & Ofoegbu, 2011). Advertising is described as any payment form of non-individual presentation and promotion of ideas, goods and services by a sponsor that is identified (Kotler & Armstrong, 2010). Sales promotion is another component of selling and marketing cost which is making goods and services be more attractive to customers. There is a positive relationship between the effective implementation of sales promotion and sales of the firms which leads to increase in profitability. The suitable model for relational capital is developed by selling and marketing cost which extracted from income statements.

Satisfaction of personal directly measured by payment to them, as the proxy of HC and satisfactions of customers is created by preparing a good situation for them by marketing, advertising and promotions, as the proxy of relational or customer capital. These two strategic groups have a tremendous effect on the firms' profitability in both aspects financially and economically. Some portion of firm's benefit that is not related to these groups are considered as structural capital.

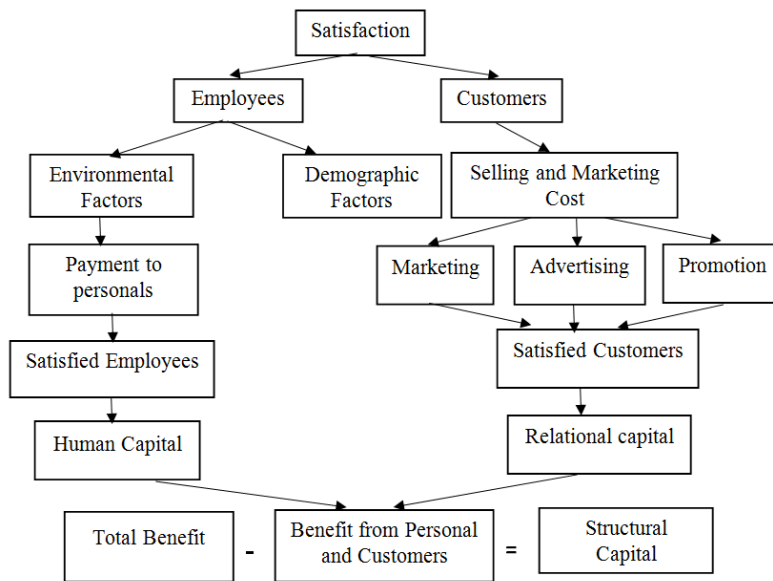
#### *Malaysian Economic Situation and Financial Market*

Today the economy of Malaysia is shifting from industry-based to a knowledge-based economy to achieve the vision 2020 and to become a developed economy. Malaysia has made significant investments in developing efficient and well-regulated financial and capital markets, in order to strengthening the institutional framework for the regulation of

the profession of accounting and auditing. Malaysia has moderate levels of economic and political risk and low levels of financial system risk. Southeast Asia is a critical part of the world trading system and while the region's economies remain somewhat dependent on agriculture manufacturing and services has been the engine for growth. Inflation is projected at 3.3% in 2014. The size of the Malaysian bond market is comparable to that in more developed markets. It is the largest in ASEAN and third largest in Asia as a percentage of GDP. The Malaysian Stock Exchange, known as Bursa Malaysia, consists of three boards, namely, Main Board, Second Board and Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) Market. Generally, the Main Board is for more

established companies, Second Board is for relatively MESDAQ Market and smaller companies, is for technology companies and high growth. Both the Second Board and MESDAQ Market provide are the way for relatively smaller companies to access the capital market early to fuel their expansion plans.

By concentration on environmental factors that the most important part of them is monetary needs of employee's, human capital proxy is developed. Both HC and RC create benefit for the companies, by deducting these benefit from total firms' benefit structural capital is developed. The reason of choosing this method for SC is that, firms have different source of infrastructures and each source create own benefit or value for those firms.



Source: Derived by Author

Figure 1: Satisfactory design of Intellectual Capital

### 2.1. Proposed Correcting Entries of Intellectual Capital

To record correcting entries of intellectual capital components in accounting journal, some costs like personal cost and advertising, marketing, promotion, sales person salaries and

so on are closed to the human and customer assets, in fact they are transferred to these accounts. Sine structural capital in present study is a part of gross income that is not provided by employees and customers and belong to the company, automatically be

included in the retained earnings account. To record SC in journal, structural assets is debited and income summary is credited. With following records reclassification of income statements is happened. So that some accounting item have been considered as cost (expense) but now by these records they are entered to the balance sheet as an assets.

1.) Personal Cost			
xxx			
Selling And Marketing Cost			
xxx			
		Cash\ Payables	
		xxx	
2.) Human Assets	xxx		
Customer Assets	xxx		
		Personal Cost	
		xxx	
		Selling And Marketing Cost	
		xxx	
3.) Structural Assets			
xxx			
		Income Summary Account	xxx

In the second article cost of personal and selling are transferred to the assets then income summary are increased by those amount since by decreasing the cost or expenses account the level of earning is increased and income summary will be credited by that amount. Then the ending balance of income summary is closed to Retained earning account and Retained earnings is closed to the intellectual capital components. As follows:

4.) Income Summary			
xxx			
Personal Cost			
Selling And Marketing			
Structural Assets			
		Retained Earning	xxx

5.) Retained Earning	xxx		
		Human Capital	xxx
		Customer Capital	xxx
		Structural Capital	xxx

**2.2. Intellectual capital components and corporate performance**

(Riani et al., 2014) examined the impact of executive compensation on bank performance and risk taking behavior using data for Indonesian commercial banks. They find the monetary compensation could lead to higher performance. Based on the finding of (Dash et al., 2013) human capital has the negative effect on the cost of capital and positive effect on EVA. (Banghøj et al., 2010) by designing and implementing of compensation schemes proved that it is strong motivation for employees that improve the performance of the company. (Ghouri et al., 2011) revealed that proper marketing communication methods like promotion and advertisement which add excellence in business activities and strengthen the competitiveness and market share. The study of (Joshi & Hanssens, 2004) is about Michael Jordan's much-publicized return to the National Basketball Association resulted in an average increase in the stock market adjusted values of his client firms of almost 2%, or more than \$1 billion in market capitalization.

(Odunlami & Ofoegbu, 2011) conduct on the issue of sales promotion depicts that sales promotions have noteworthy impact on the sales and profit of the organization. (Malshe and Agarwal, 2011) used data from more than 200 firms over a 15-years period spanning 1994 and 2008. He proved that on average 20% increase in leverage (ratio of debt to firm value) results in 1 point decrease in customer satisfaction. (Shakina & Barajas, 2012) which OLS method is used for their regression equation coefficient estimation and have proved that the average level of EVA is negative in relationship with structural capital

for both Russian and European samples. Although, for the European firms their mean of EVA is less negative than for the Russian ones. (Himmel & Fisher, 2011) proved that higher satisfaction ratings of customers reduced the cost of equity.

(Boujelbene and Affes, 2013) examined empirically the impact of intellectual capital disclosure on cost of Equity capital in the 120 companies listed in the French. They proved that, the Relational capital disclosure coefficient has a negative but not significant association with Cost of Equity Capital within the whole sample, the traditional and the high tech one. In the study of (Fiala and Borùvková, 2011a) SC in the field of accounting are used 2796 firms in the Czech Republic. Their results shows that statistically important linear correlation between structural capital and ROE, has been established.

### 3. METHODOLOGY

#### 3.1. Research Hypotheses

- 1) The improvements of explanatory variables of intellectual capital, lead to improvement of the Firm's financial performance.
- 2) The improvements of explanatory variables of intellectual capital, lead to improvement of the revenue growth.
- 3) The improvements of explanatory variables of intellectual capital, lead to improvement of the Firm's Economic performance.

#### 3.2. Research method

Surveys by correlation method is used in this study method to determine and predict the direction and strength of relationship between variables. The research is quasi experimental since, the observations are not live creation and the experiments have not been done in exact laboratory. To prepare a quasi-determining framework the pooled OLS by random and fixed effect have been utilized. The econometrics analysis of panel data, by E-views software is conducted.

#### 3.3. Variables

Variables of research are classified as independents, dependents and control variables. Independents includes human, relational and structural capital. Dependents variables include return on equity (ROE), revenue growth (RG) and economic value added (EVA). To be harmonized variables with the components of IC, EVA have some adjustments.

$$EVA = (\text{Return on Equity} - \text{Cost of equity}) \times (\text{Invested capital}) \quad (1)$$

Personal (staff) cost include, salaries, bonus, allowances and overtime pension costs and defined contribution plans, social security costs and compensatory benefit attributed to personals. The data for HC is extracted from the Notes to the Financial Statements under the heading "Staff Costs" or "employees benefit" for the group of the companies. Selling and marketing cost has taken from consolidated income statement for the group of companies. The SC is calculated by differential method and its data extracted from consolidated financial statements.

$$IC = HC + RC + SC \quad (2)$$

$$HC = \text{Personal Cost} / \text{Annual Revenue} \quad (3)$$

$$RC = \text{Selling and Marketing cost} / \text{Annual Revenue} \quad (4)$$

$$SC = (\text{Gross Profit} / \text{Annual Revenue}) - (HC + RC) \quad (5)$$

The Debt-to-Equity ratio and natural logarithm of total assets (as the proxy of firm's size) are used as control variables.

#### 3.4. Sample Size

Disproportionate stratified random sampling at initial stage is used as a method of sampling. Some limitation related to the data gathering are exerted, if exist. The financial statements do not exist in some years and if they are, they are not compatible with the models. In present study, these limitations include:

- The fiscal or financial year of the firms in the sample should be ended to the December 31.
- Companies should cover the time scope of this study.
- The expenses structure of income statements for selected companies should include the class of selling and marketing cost.

$$ME = z * (\sqrt{(p.q)}) / \sqrt{n} \tag{6}$$

Where:

ME = Margin of error

z = Confidence level, this research uses 90% confidence level, z-score = 1.645

p = Estimate of population proportion. The cautious approach is to use p = 0.5 because this will determine the largest sample necessary regardless of the true proportion

Rearranging formula (6) in order to solve for n, provides the following equation:

$$\sqrt{n} = (z * \sqrt{(p.q)}) / ME \tag{7}$$

Based on the available time to collect the data and conduct the analysis, an ME of 10% was considered appropriate for this study. Hence, it was decided that a sample size of n = 67 would be sufficient. After applying limitations the final sample is 36 Malaysian firms from eight industries.

#### 4. DATA ANALYSIS

$$ROE_{it} = \beta_0 + \beta_1 HC_{it} + \beta_2 RC_{it} + \beta_3 SC_{it} + \beta_4 SIZE_{it} + \beta_5 DE_{it} + U_{it}$$

**Table 1: ROE and components of IC**

		ROE	
Explaining variables	Symbol	Coefficients	Prop
Human Capital	HC	0.302019**	0.0741
Structural capital	SC	0.325364*	0.0009
Relationship Capital	RC	0.478949*	0.0443
Debt to equity ratio	DE	-0.154964*	0.0000
SIZE	SIZE	0.071907#	0.3088
$R^2$		0.305275	
F statistic		4.152829	
Hausman $\chi^2$		0.0000	

Source: Researcher's findings

In the table 1, Impacts of intellectual capital components on the return on capital equity have been investigated. At the first level of analysis, it will show that the effect of human capital on ROE in the significant level of 10% is positive. Present finding support the results of (Maditinos et al., 2011).

In the second and third level of analysis the effect of SC and RC on ROE is examined. The result of the test shows that in significant level of 5% there is a positive and strong relationship between those. Present model is supporting the result of (Fiala and Borůvková, 2011; Mehdivand et al., 2012; Saeedi et al., 2012b). Debt to equity ratio in the significant level of 5% has the negative effect on the return on equity. In the second level of control variable analysis effect of firm's size on ROE has been explored, the result shown that, firm size has not significant impact on the ROE.

$$RG_{it} = \beta_0 + \beta_1 HC_{it} + \beta_2 RC_{it} + \beta_3 SC_{it} + \beta_4 SIZE_{it} + \beta_5 DE_{it} + U_{it}$$

**Table 2: RG and components of IC**

		RG	
Explaining variables	Symbol	Coefficients	Prop
Human Capital	HC	-2.151781	0.0002
Structural capital	SC	1.571958	0.0000
Relationship Capital	RC	1.702458	0.0667
Debt to equity ratio	DE	0.016490	0.7511
SIZE	SIZE	-0.026367	0.9454
$R^2$		0.121109	
F statistic		1.988699	

Source: Researcher's findings

In the table 2, Impacts of intellectual capital components on the RG have been investigated. The obtained output shows that, in the significant level of 5% the effect of HC and SC on RG is significant but HC are negatively correlated to RG. The finding is consistent with (Chidiebere, 2013; Lev & Radhakrishnan, 2004). Relational capital in the significant level of 10% has significant and positive relationship with revenue growth. This result support the findings of (Banerjee et al., 2012; Odunlami & Ofoegbu, 2011). Firm size and

debt to equity ratio have not significant relationship with revenue growth.

$$EVA_{it} = \beta_0 + \beta_1 HC_{it} + \beta_2 RC_{it} + \beta_3 SC_{it} + \beta_4 SIZE_{it} + \beta_5 DE_{it} + U_{it}$$

**Table 3: EVA and components of IC**

		EVA	
Explaining variables	Symbol	Coefficients	Prop
Human Capital	HC	3.292419*	0.0439
Structural capital	SC	-1.780956**	0.0913
Relationship Capital	RC	4.142061*	0.0487
Debt to equity ratio	DE	0.640127**	0.0781
SIZE	SIZE	1.038026#	0.368
$R^2$		0.515250	
F statistic		8.611391	
Hausman $\chi^2$		0.0000	

Source: Researcher's findings

In the table 3, Impactsofintellectual capital components on theeconomic value addedhave been investigated. Analysis demonstrate HC and RCrelationship with EVA, in the significant level of 5% is a positive and significant relationship. The result support the finding of(Dash et al., 2013;Boujelbene & Affes, 2013; Joshi & Hanssens, 2009). Adjusted  $R^2$  indicate that more than 50% of EVA variation can be explained by the change of intellectual capital components.Structural capital in the significant level of 10% has the significant and negative impact on EVA. Cash dividends paid to common stockholders is the key factors that increase the cost of equity especially in present model, based on the study in the case of IBM Company. It shows that organizational/structural capital has positive impact on its dividend between the years 2011-2012. Increasing it from 3,473 billion dollars to 3,773 dollars (more than 8% increase).(IBM Annual Report, 2012).

**CONCLUSION**

By increasing the investment on the employee's payment as the proxy of human capital enhanced functional performance by increasing the level of functional performance, financial performance will also increase.

Payment to personal will increase their satisfaction, this satisfaction will improve theirfunction in the firm and will reduced the organizational cost by decreasing the level of duplications and errors. Then can conclude that, monitory satisfaction of personals will increase the effort of employees this matter leads to the increase of task performance and finally financial performance.As mentioned before structural capital is a part of firm's benefit which are affected by the organization's infrastructures. Based on the obtained result, there is a positive and significant relationship between the structural capital and return on equity.Investment on marketing, advertising and sale promotion and many items that existed in the selling and marketing cost classes in the income statement will lead to a subject that called dynamic market capability, based on this phenomena market will open its door to the firms in fact at this time market will select the company and there is no need the company is looking to market.

Anticipation of the current study was that increased payments to employees will be direct increase in the revenue but the obtained results show the inverse relationship existed between HC and revenue growth. By contemplating the findings of previous studies, can be inferred that, in payment to personals, should pay attention to structure of payments. It means which items should grow in the payment structure to increase the revenue of the firm. Another issues that can lead to revenue growth is the economic position of the company. According to prior study, the behavior of employees in rapid growth firm vs. low growth firm was different than the payment's item.In rapid growth firms employees prefer to be shareholders of the firm, then ownership of financial instrument like stock option, warrant and other will stimulate these kind of personals to work efficiently.

In present study the positive impact of human capital on profitability are proved but always increase in profitability ratio is not meant that the direct and positive relationship between human capital and revenue or sale are existed. This meant that the quality of payment's item intervene in revenue growth. If



feeling of an ownership interest provided by companies for employees, firms is started to attract and retain high-quality employees, and they reduced the portion of a firm's business risk to the employees, then can conclude that the payment will increase the level of revenue when many parameters of monetary incentive are considered.

Based on the obtained result structural capital model that measured based on the residual benefit directly and positively have relationship with revenue growth in the significant level of 95%. In the study of IBM Company, 19 billion dollars in revenue growth analysis demonstrate that 10 billion of this growth just related to structural capital.

To analyze the elements of selling and marketing cost, attention to the marketing, advertising and promotion and their relationship can justify these positive effects. In the company between the consumers and its products a strong relationship will be established by marketing communication and prepare those consumers to have judgment in comparing the products with other firms' products and facilitate them in buying the products. Demands have also improved by advertising for current product and it also create demand for new product, thus leads to increasing in the firm's sale. Sales promotion have also benefit to the organizations at all stages of life cycle of a product, in particular at initial and growth stage.

In the measurement of EVA the ROE is replaced as an alternative factor for ROI. Then the cost of equity by the growth model is measured as other alternative factor for cost of capital. Human capital as mentioned before by present model will reduced organizational cost and will increase the ROE, ROE is the increasing factor for EVA. Based on the prior research HC will reduced the cost of equity and since this element is decreasing factor for EVA, HC have another increasing effect on EVA, in measurement of EVA growth of dividend is increasing factor for cost of equity and decreasing factor for EVA. Structural is the part of firms benefit, by growth of this benefit the motivation and incentives of the firms to dividend payment will increase this

matter will reduced EVA. Based on the obtained result, in the significant level of 90% there is a negative association between the structural capital and economic value added.

Relational capital have positive effect on ROE based on the earlier findings in this study, another positive effect of relational capital on economic earning parameters related to its increasing effect on stock price based on the findings of other research (Advertisement of Michel Jordan increased the company's stock price to US \$ billion), then RC have positive effect on stock price and because in the cost of equity stock price is decreasing element (growth model), RC have positive and significant effect on EVA by decreasing the cost of equity.

#### **Recommendations for future research**

- 1) Employee's satisfaction with using employee benefits as the proxy of human capital are used in this study, payment influence and its impact on the level of personal satisfaction by questionnaire are suggested to future researchers.
- 2) Customer satisfaction as the proxy of relational capital is tied to selling and marketing items. To future study proposed that, with the acquisition of questionnaire from customers obtaining their views about these items. With this information, can simulate the future behavior of customers for the purchase of goods.
- 3) In measurement of structural capital utilizing the future cash flows from firm's infrastructures as the complementary method is proposed to future researchers in accounting.

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