

**ECONOMIC VALUE ADDED AS AN INDICATOR OF INTELLECTUAL CAPITAL AND ITS
IMPACT ON FIRM PERFORMANCE: THE MALAYSIAN EVIDENCE**



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1.2 Executive Summary

The conventional accounting standards applied by most of the industrial companies nowadays focus more on the measurement of financial and physical assets, but none on intangible assets. Even the International Accounting Standards (IAS) did not come up with any attempt in redefining the principle, concept and valuation methods particularly for intellectual capital assets. It can be concluded that the eventual published financial statements are of little value to the shareholders due to the deficiency in the recognition on the importance of intellectual capital accounting (Ashton, 2005).

The objectives of the study are to assess the role of Economic Value Added (EVA) as an indicator of intellectual capital and to validate the method of EVA to evaluate the impact of intellectual capital on firms' financial performance and stock market performance. Analyses of correlation and simple linear multiple regressions were carried out on the set of variables representing both intellectual capital and firm performance as well as stock market performance. This study contributes to the scarcity, especially in the existing extant of published Malaysian-based literatures, by employing the Economic Value Added (EVA) model approach developed by Joel Stern and G. Bennet Stewart in 1989 as the benchmark indicator in determining the measurement value of intellectual capital. Malhotra (2003) argued that the EVA model approach is effective in presenting intellectual capital in its financial value and practically useful as EVA assist in comparing firm's intellectual capital within the same industry. Applying EVA provide a more straight forward communication in accounting since it is based on accounting rules that have been long established (Sveiby, 2007).

Covering a five-year period of study (2006 - 2010), the empirical research investigation will be conducted on all Bursa Malaysia listed companies (except finance sectors). Economic value added - EVATM method will be adopted in measuring intellectual capital and this is established by the following equation:

$$\text{EVA}^{\text{TM}} = \text{Net operating profit after tax} - [\text{Capital Employed} \times \text{Weighted Average Cost of Capital}].$$

This study will segregate sample of data into two different groups, firms with positive EVA (value creator) and firms with negative EVA (value destroyer). Results from the analysis show that value creator firms have no significant relationship with either firms' financial performance or stock market performance. However, value destroyer firm have a significant relationship with the Malaysian stock market performance, though do give impact on firms' financial performance.

1.3 Introduction

The prevalent phenomenon of financial statements failing to explain firms' true value has attracted a lot of research attention in investigating the widening gap between firm's market and book value (Lev & Zarowin, 1999; Lev, 2001; Lev & Radhakrishnan, 2003). As documented by Lev (2001), over the years from 1977 until 2001, it was found that the mean for the market-to-book value ratios among the US Standard and Poors (S&P) 500 corporations have increased from slightly above the value of unity to nearly six. Consistent with the findings by Stewart (2001), it was discovered that out of 3,500 listed companies, 5% difference between market value and book value was shown in the year 1978 compared to 72% as shown 20 years later. This highlighted that over the past years, intangible or knowledge based assets have obviously received inadequate treatment by the traditional accounting practices, by which they are routinely expensed off in the financial reports and thus, remain absent from the firm's balance sheet. Failure of financial statements in explaining and recognizing firm's true value has drawn wide research attention. The scenario acts as a prove that economic value no longer comes from the production of tangible goods but essentially from the creation of intellectual capital (Chen et al., 2005).

By principle, intellectual capital is the difference between the market value of a firm and its book value (Edvinsson & Malone, 1997). Although intellectual capital has many definitions, the commonly accepted one for it is that intellectual capital is the experience, knowledge, employees' brainpower and resources kept in organization's systems, databases, processes, philosophy and culture (Al-Ali, 2003).

It can be concluded that intellectual capital measurement is still not well structured in most companies due to the predicament that intellectual capital is complicated in its measurement (Andrikopoulos, 2005; Nazari and Herremans, 2007, Kim et al. 2009). Unlike tangible assets, intellectual capital are not clearly observable and their economic benefits are uncertain (Marr, 2007; Huang & Wang, 2008). In response to this, various methods were constructed and developed in measuring intellectual capital. According to Bontis et al. (1999), none of these intellectual capital measurement models can be considered as the best since each of the model is developed based on its own criteria. Different method of intellectual capital serve different purposes, therefore selection of the method should be done accordingly depending on the situation, purpose and audiences (Sveiby, 2007)

Despite numerous researches conducted in examining the various measurement approach of intellectual capital, this study will explore and