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# The Impact of Intellectual Capital on The Performance of Islamic Banking

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## ABSTRACT

**Intellectual capital becomes the integral part in the development of successful organization lately. Most of the organizations and banks in Islamic countries and Iran are started to shift in practicing intellectual capital since knowing the important of it. Intellectual capital is defined as intangible assets that include technology, customer information, brand name, reputation and corporate culture that are invaluable to a firm's competitive power.**

**In a contemporary business environment, intellectual capital is considered as the most critical strategic asset for the success of the organization. Intellectual capital is a life blood of the high -tech and knowledge intensive organizations. Banking sector is considered as a know ledge intensive segment. Therefore, there is a great need to nourish the concept and applications of intellectual capital in banking sector. In Islamic countries, banking sector is mainly based on conventional banking sector and Islamic banking sector. The purpose of this research is to consolidate these findings and investigate three elements of intellectual capital including human capital, structural capital and customer capital and their internal relations in the Islamic banking industry.**

## KEYWORD

**Intellectual capital, Islamic banking, Human capital, Structural capital, Capital Markets.**

## INTRODUCTION

In the past, everyone believed that the performance of any organization depends on managing expenses and financial items but today this approach loses its absolute meaning and it has been assumed that eighty percent of enterprise performance refers to proper management of intellectual capital items. Even, some people believe that organization's financial success depends on the success of the intellectual capital items this means that items of intellectual capital affect organization's financial performance and banks. Until the early 1950s, the main cause of backwardness in developing countries has been considered lack the financial and physical capital. But today, it is obvious that injection of large quantities of physical and financial capital necessarily doesn't accelerate growth and development in these countries. Countries with strong institutions and effective governance institutions yet have efficient and professional human capital that can more efficiently absorb their financial and physical capital and use them in accelerating development process. In the new economy, generating wealth and economic growth mainly comes from intangible assets, especially intellectual capital.

Intellectual capital is increasingly acceptable as an important factor for sustainable corporate advantages. The results underline the importance of intellectual capital in enhancing firm profitability and cost efficiency. Developing intellectual capital is no less important than capital investments for companies. Therefore, Intellectual capital should be increasingly recognized as one of the major investment for driving the company's sustainable growth, together with the other factors of production.

In an organization intellectual capital is used to create value addition features in their products and services. In competitive environment high-tech industries or knowledge based organizations mainly based on the knowledge assets which refer to intellectual capital. Banking sector is considered as the knowledge intensive sector, and this sector mostly offers services orientated products to their customers.

Iranian banking sector is based on Conventional and Islamic Banking Sector. In Iran, these both sectors are performing on parallel lines and their significant positive contribution in the development of economics is highly recognized by the government. In previous studies, researchers mainly focused on Conventional Banking Sector while the Islamic Banking Sector got insignificant attention from the researchers, therefore, in this study, the researchers focused on Islamic Banking Sector to examine the role of intellectual capital in order to enhance the organizational performance.

## MEANING AND CLASSIFICATION OF INTELLECTUAL CAPITAL

There are a lot of definitions of intellectual capital:

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SCIJOUR

Intellectual capital has also been defined as the difference between a firm's market value and the cost of replacing its assets. It is those things that we normally cannot put a price tag on, such as expertise, knowledge and a firm's organizational learning ability3. value equals book value plus intellectual capital, with book value usually only the tip of the iceberg of wealth.

Capital, in the business context, refers to any asset that will produce future cash flows. The most well known asset types are tangible in nature. Tangible capital therefore refers to the physical and financial assets of the organization. The value of such assets is disclosed periodically (by publicly listed companies) and can be found easily on the balance sheet of the Company's financial records. Physical assets can mean land, machinery, inventory, plants, trucks, etc. whereas financial assets refer to the shareowners equity, retained earnings, working capital, prepaid expenses, accounts receivables, etc. Intangible assets on the other hand, such as the skills of the workforce and its organization, are increasingly becoming important towards determining future profits. However, they are much harder to determine, harder still to quantify into a value and therefore are never reported. Hence these types of assets remain largely invisible to the external world – and more often than not to insiders as well.

Researchers classify intellectual capital as consisting of human, structural and relational capital (Abeysekera, 2003). However, the values inherent in the human, structural and relational capital of an organization remain hidden, and are not disclosed in its financial records.

Thomas Stewart, a pioneer in the study of such intangible assets, is credited with having coined the term 'Intellectual Capital' to refer to these assets. After more than a decade of studies by various other scholars in this area, there is general agreement that Intellectual Capital itself is composed of three distinct types of capital - Human Capital, Structural Capital and Relational Capital.

• Human Capital is the availability of skills, talent and know-how of employees that is required to perform the everyday tasks that are required by the firm's strategy.

• Structural Capital is the availability of information systems, knowledge applications, databases, processes and other infrastructure required to support the firm in executing it's strategy.

•Relational Capital is the external linkage of the Company with Suppliers and Customers that enables it to procure and sell goods and services in an effortless manner.

Table.1. Intellectual capital performance indicators

| Human capital | Structural capital | Relational capital |
|---|---|---|
| • Personnel cost/revenue<br>• Revenue/ employee<br>• Staff turnover rate<br>• Recruitment, training and development spent per employee | • Research and development expenditure/ revenue<br>• Intellectual property/total assets | • Marketing, selling and distribution costs/revenue<br>• Business segments level<br>• Geographical segments level<br>• Market share<br>• Market growth |

**SOURCE: VERGAUWEN ET AL (2007: 1163) ADAPTED**

An evaluation of the efficiency of the physical capital and intellectual potential of the major European banks for the year 1996 was another work that can be noted in this context (Pulic Ante, 1996). The results of the study indicates that intellectual potential is of crucial importance for corporate success and therefore, a obvious conclusion comes up that rising the efficiency of intellectual potential is the simplest, cheapest and most secure way to ensure sustainable business success.

## INTELLECTUAL CAPITAL DISCLOSURE

The failureof financial statement in informating the ability of creating value of intangible asset ( Lev and Zarowin , 1999 ) , increasing the information asymmetry between the firms and the users of the financial accounting ( Healy and Palepu , 2001 ) . This information asymmentry creates inefficiency on the resources allocation process on the capital market ( Li , Pike and Hainffa , 2008 ) .Rylander et al . ( 2000 ) reviewed the major issues of intellectual capital disclosure and summarized them as follows :

1 .the information asymmentry gap is growing as the proportion of company value attributable to intangible assets increases .

2 . long term information , particularly on strategic intent and execution , was laking from company reporting but was considered to be of particular importance to external stkeholeders , especially the investors .

3 . standards and comparability relating to the disclosure of intellectual capital would remain a major issue .

4 . value creation models could provide information to complement traditional reporting required by law ( Bontis ) .On other hand ,the European commission ( 2006 ) emphasizes two main reasons for intellectual capital reporting :1 ) reporting of intellectual capital provides additional information which can be used to improve the management of the company as a whole .2 ) reporting of intellectual capital complements the financial statement of the company and therefor provides a broader , more truteful image of the company . ( basta . and bertilsson , 2009 ).

ICD is defined by Abeyesekera and Guthrie ( 2002 ) as a report intended to meet the information needs common to users who are unable to command the preparation of reports about ic tailored so as to satisfy ,specifically all of their information needs ( Gan et al.2008 ) .

## INTELLECTUAL CAPITAL REPORTING AND THE CAPITAL MARKETS

Internal strategic decision-making and external disclosure should focus on IC information such as staff competencies, managerial capabilities, customers and suppliers relationships, strategic collaborations, R&D, and organizational systems etc. Guthrie et al. (2001) identified two evolving intellectual capital (IC) missions; (1) ‘developing systems for creating, capturing and disseminating IC within organizations' for internal strategic decision-making and (2) ‘establishing new measures and ways of reporting externally the value attributable to IC’. The latter mission addresses information needs of the managers for internal management of the company and information needs of investors for valuing the firm as an investment opportunity.

Unlike annual report that focus on historical performance, a prospectus provides information that focus on the company’s future perspectives. Cordazzo (2007) asserts that prospectus offers additional information on the companies’ long term strategy, company risk and future profitability, and it is generally more forward oriented than annual report. These differences are likely to be reflected in the disclosure practices of the two documents. However, literature on intangibles or intellectual capital disclosure study comparing between prospectus and annual report is scarce. In a slightly similar study, Nielsen et al. (2006) observed similarities between prospectuses with intellectual capital statements. They further argued that a common framework for analyzing business reporting could be developed based on the findings.(Azwan Abdul Rashid, Wan Mohammad Taufik Wan Abdullah, MahlindayuTarmidi and ZaifudinZainol) . According to lev and Zambon( 2003 ) , economic development in recent years has been characterized by continuous innovation , the spread of digital and communication technologied , the relevance of network forms of organization , and the prevalence of soft , intangible and human factors . firms operating in competitive , global markets recognize that the traditional reliance on tangible assets as value drivers , has been supplemented – or even superseded – by softer , intangible asset forms . Hence , for most organizations , intellectual capital is now recognized as an integral part of the firms value – creating process ( Bukh , 2003 . Holland , 2003 ) .

## A GROWING NEED TO REPORT THE EXISTENCE OF INTELLECTUAL CAPITAL

The increasing importance of intellectual capital and the growing number of companies that rely on these assets in order to create value have created a need to inform the market, the investors and the other stakeholders of the existence of intellectual capital (OECD, 2006:5). Both the accounting and reporting of intellectual capital are, thus, important if the stakeholders of a company are to be allowed the opportunity to make informed investment and other decisions. Seetharaman et al (2002:132) note that it would definitely not be in a company’s interests to ignore the existence of intellectual capital and not to make a concerted effort to measure and manage this asset. Capital providers might make investment decisions based on the information recorded in the annual financial statements of a company and this may result in incorrect decisions. that may harm the company if the information recorded in the annual financial statements does not accurately reflect the financial position of the company, especially in the case of companies holding more intellectual capital than physical assets.

## ACCOUNTING DEBATE ON INTELLECTUAL CAPITAL

Much time and effort have been expended over the past few decades in debating the reforming of the accounting standards so as to include a wider range of assets than previously in the statement of financial position. The results of the study conducted by Marr and Moustaghfir (2005: 1120) suggest that the debates on intellectual capital started as early as the mid 1960s. However, during this period there was no universal definition or classification of intellectual capital in place as a result of the fact that there was still much that was unclear about its nature, and the way in which these assets work (Marr & Maustaghfir, 2005: 1120). However, the topic of intellectual capital was later researched by a number of researchers who identified and analyzed different classes of these assets. The debate on the topic also forced the IASB to include certain of the intellectual capital categories in its definition of intangible assets.

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http://www.scijour.com/ijbe
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Table.2. Accounting debate on intellectual capital

| Arguments in favour of recognizing intellectual capital in financial reporting | Arguments against recognizing intellectual capital in financial reporting |
|---|---|
| - Closes the gap between the book and the market values | - Does not meet qualitative requirements of the information in terms of the IASB |
| - Provides information about the real value of the organization | - Does not meet the definition and recognition criteria of an asset |
| - Reduces information asymmetry | |
| - Enhances the reputation of organizations | |

## THE VALUE INTELLECTUAL CAPITAL IN BANKS

There is a transformation continually in the world. People, organizations, banks and governments is affected by transformation. The idea of intellectual capital started a decade or so ago, as two trends began to emerge: 1) the shift from production-based economies to service and knowledge-based businesses; 2) the notion of "the invisible balance sheet". Intellectual capital has more value for banks and organizations than physical assets.

Knowledge has been recognized as a valuable resource by researchers. intellectual capital simply means the knowledge resources of bank. Success of banks depends on creating , discovering, capturing, disseminating, measuring knowledge. If organizations and banks enhance their organizational learning, they will increase their knowledge and intellectual capital. Learning suggests ongoing, never-ending and always changing. It is the foundation of adaptability and innovation. The economic value of learning is a given because of its role in most business decisions and transactions.

## THE INTELLECTUAL CAPITAL PERFORMANCE OF BANKING SECTOR

Presently, banking sector plays a crucial role for development and growth of the national economy. Banking sector performs as a lever to facilitate the financial transactions. Competitive environment and globalization business challenges has forced to organizations to reshape into knowledge intensive organizations rather than traditional. When knowledge-intensive organizations tend to dominate in the competitive finance sector, there is a need to capitalize the organizational resources, especially intellectual capital. Like other countries, in Iran the banking sector is playing vital role for the development and growth of economy. It can also consider as the banking sector is a back of bone of economy, particularly in present time banking sector involve in every segment of our life

The banking industry has been undergoing dramatic changes over the last decade, with both structural and technological advances pressing top management to rethink their business strategies. Financial globalization, intensified competition, Information and Communication Technology (ICT) developments, deregulation and (re)regulation are the principal drivers for change.

The changing nature of banking, where banks are moving from on-balance to off-balance sheet activities, together with an increased involvement in capital markets, have created a need for skills and transaction systems that are quite different from those of traditional lending. These new technological and organizational challenges have resulted in a demand for new skills. Additionally, the risk profile of banks is changing both in its composition and its complexity, making intellectual capital assessment a vital element in banking strategies.

Previous studies (Bontis, 1998; Bontis, Keow and Richardson, 2000) confirm a very strong and positive relationship between intellectual capital and business performance. However, we recommend that this link should be confirmed in other international settings and in specific industries.

In a competitive and turbulent environment, banks recognize that most existing interaction depends on ICT. Banks and their customers have become more flexible and Intellectual capital and business performance more communicative, partly owing to new technology and partly due to a higher level of education and greater competence. In addition to reducing costs, ICT helps improve quality through the provision of real-time operations, constant updating of customer information, reduced delays, increased reliability of outputs and standardization of decision-making. Customer creation-value does no longer lie in a single transaction. It is nurtured and developed over a lifetime. Consequently, dynamic interaction between structural capital and relational capital is a fundamental goal for banks.

## THE ROLE OF FINANCIAL AND PHYSICAL ASSETS IN INCREASING THE VALUE BANKS

The role of financial and physical assets owned by a firm is losing its importance in an economy which is dominated by service sector. Intangible assets that create value for the firm are quickly gaining importance. The share of intangibles as a proportion of the total assets also is showing tremendous increase in the recent years. As a result every organization now finds logic in measuring, valuing and reporting its intangibles, as they also have become one of the important performance indicators and a strategy to gain competitive advantage.

The present accounting system does not support the measurement and reporting of intellectual capital in most developing countries. Therefore there is an immediate need to develop a new accounting standard that takes into account the growing importance of Intellectual capital. These

changes are more compelling in some sectors with specific reference to service sectors like banks and financial institutions, Hotels, Tourism sector, Information and Technology Industry, Education etc, where the role of Human capital is much more evident among the other components of intellectual capital.

Efficiency in using of resources plays an important role in determining the strength of the organization. An organization may be small or big, what is more important is whether it is using its limited resources in a proper manner so as to increase the long-term sustainability in a competitive market. Increase in the value is the major objective of most commercial firms; banks are no exception to this. Measuring the increase in value also becomes challenging when the value itself is being created by intangibles.

## ISLAMIC BANKING

Based on the resource based theory (RBT), banks rely on a number of different resources and capabilities which is non similar such as financial resources and tangible assets, also intangible assets, such as com

pany's fame, culture, and human capital. Based on the resource based theory (RBT), banks rely on a number of different resources and capabilities which is non similar such as financial resources and tangible assets, also intangible assets, such as company's fame, culture, and human capital.

The countries comprising the GCC have notable common economic, cultural, and political similarities which counteract the differences they have[2]. Therefore, by adopting suitable economic and financial policies for banking sector efficiency is the main objective of the GCC countries, wherein they plan to transform their current economy into global financial and trade centers[3]. Owing to the essential element of IC as a resource in the success of banking.

Islamic banks in the GGC control a market share close to 15% of the regional banking system’s assets, and have become great component of financial intermediation in this part of the world. Islamic banks in the Gulf Cooperation Council (GCC) has grown exponentially and become more diverse: there are new entrants, conventional financial banks have been converted to banks that work according to the rules of Shariah, and conventional banks opened Islamic windows, forcing Islamic banks to enhance their commercial entrenchment, increase relevant business models, strengthen their brands and reputation and supply innovative solutions to a growing number of clients attracted by the idea of Riba-free banking.

## PERFORMANCE OF INTELLECTUAL CAPITAL IN THE BANKING INDUSTRY

Since the development of the new economy underscores the fact that the value creation mostly depends on intangible assets rather than physical assets therefore, in this economies, intellectual capital is the main source of economic development and other traditional factors of production such as land, labor, and financial capital are important in the next place. In such circumstances, intellectual capital is a key factor in organizational performance improvement.

Due to the underdevelopment of the banking system in developing countries and many Muslim countries and the lack of competition with global banking and exploiting intellectual capital and knowledge, there is a wide field for the progress in which significant gains can be achieved by work and efforts. The performance of intellectual capital in the banking industry is discussed to determine to what extent the existence of intellectual capital in organizations is emphasized. Similarly, some researches have been conducted in the banking industry to measure intellectual capital. Pulic measured the intellectual capital in the Austrian banks during 1993-1995 and in Croatia's banks during 1996- 2000. The results of these two studies indicated a significant difference in the ranking of banks based on traditional accounting and performance measures. Pulic study showed that in many service firms the intellectual capital is not considered aligned with financial and physical capitals (Pulic, 2001).

Using the same model, Mavridis also studied the performance of Japanese banks. He also indicated a significant difference among banks different groups (Mavridis, 2004). Cabrita and Bonits in the Portuguese banking industry have had the same conclusions, while human capital has many effects on other components of intellectual capital, but its impact on organizational performance, is indirect. In addition, human capital not only directly, but also through structural capital investment will affect the customer (Cabrita and bonits, 2008).

## CONCLUSIONS

Reviewing studies on the relationship between intellectual capital and organizational performance revealed that in most research on intellectual capital, three dimensions of human, structural capital and customer-centered capital have been mentioned and in performance field the three factors of profitability, productivity and market value to book value of the company has been considered. Due to the underdevelopment of the banking system in developing countries and many Muslim countries, and the lack of competition with global banking and exploiting intellectual capital and knowledge, there is a wide field for the progress in which significant gains can be achieved by work and efforts. The performance of intellectual capital in the banking industry is discussed to determine to what extent the existence of intellectual capital in organizations is emphasized.

Thus, the results showed that intellectual capital is significantly related to organizational performance of Islamic banking industry and the highest rate of positive effects is related to human capital, structural capital and customer capital. In addition, intellectual capital is a phenomenon of interaction. Study on intellectual capital provides remarkable value of energy, energy that can progress companies and banks even further the current view. It is necessary to review the attitudes of intangible assets,

beginning to identify, measuring and managing strategic knowledge.

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