# DISCLOSURE OF INTELLECTUAL CAPITAL INFORMATION, FIRM VALUE AND INTANGIBLE ASSETS VALUE: A STUDY ON TOP 50 BRAND COMPANIES IN MALAYSIA

BY

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A dissertation submitted in partial fulfillment of the requirement for the degree of Master of Science in Accounting

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# ABSTRACT

FRS 138 specifically provides that internally generated goodwill, brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognized as assets. Therefore, brands are not recognized by the companies because they are internally developed. However, external consultants do assess and evaluate the brand value of companies in UK, Australia, Singapore and including Malaysia. The external consultant is able to derive at some reliable measure to obtain the brand values of companies in some countries. This study aims to find whether brands are value relevant to the users. The total identifiable capitalised intangible asset is also found to be related to the firm value. This study reports the results that in addition to traditional measures, brands also adds value to the users and stakeholders in their decision making process. Further, this study seeks to measure the intellectual capital performance of the top 50 brand companies in Malaysia. The findings allowed the companies to acknowledge their efficiency ranking, to establish priorities in developing their strategic management plans which in turn will affect their future performance.

# ملخّص البحث

ف ر س 138 تحديدا على أن حسن النية المتولدة داخليا، العلامات التجارية، والترويسات، ونشر عناوين، لا ينبغي قوائم العملاء والبنود المشابهة من حيث المضمون بوصفها أصولا. ولذلك ، لا يتم التعرف على العلامات التجارية من قبل الشركات لأنها وضعت داخليا. ومع ذلك، لا استشاريين خارجيين تقييم وتقدير قيمة العلامة التجارية للشركات في المملكة المتحدة واستراليا وسنغافورة وماليزيا بما في ذلك. الخبير الاستشاري الخارجي قادر على اشتقاق في بعض قياس موثوق بها للحصول على قيم العلامة التجارية للشركات في بعض البلدان. تهدف هذه الدراسة إلى البحث عن العلامات التجارية هي ما إذا كانت القيمة ذات الصلة للمستخدمين. ويمكن التعرف رسملة مجموع الموجودات غير الملموسة وجدت أيضا أن تكون متصلة قيمة الشركة. هذه الدراسة على نتائج تقارير أنه بالإضافة إلى قياس التقليدية، والعلامات التجارية أيضا إضافة قيمة للمستخدمين وأصحاب المصلحة في عملية صنع قرارهم. وعلاوة على ذلك ، تسعى هذه الدراسة لقياس أداء رأس المال الفكري للشركات أفضل 50 علامة تجارية في ماليزيا. وأتاحت نتائج الشركات للإعتراف ترتيبها الكفاءة، وتحديد الأولويات في وضع خطط لإدارة الإستراتيجية والتي بدورهاسوفتؤثرعلى الأداء في المستقبل.........................................

# APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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Supervisor

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# DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Inaliah Mohd Ali

Signature ………………………………………    Date ……………………..

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# CHAPTER ONE

# INTRODUCTION

## 1.1    OVERVIEW

The issue of value relevance of intangibles non current assets is important in the financial reporting literature due to the ever increasing interest in the components of intangibles assets items including goodwill and intellectual capital (Shukor et. al., 2008). The latest issued IFRS 3 and IFRS 138 have created the need for valuation of intangible assets for financial statement purposes. The standards address only for intangibles acquired in a business combination, but the question arises of what values remain hidden within intangibles developed internally. Given that adoption of IFRS, it is important for investors and stakeholders to understand the association between accounting numbers prepared using the current accounting standards and equity value. This will help the stakeholders to estimate the value of equity after adoption of IFRS.

With IFRS adopted by some countries, and with other countries also moving to adopt IFRS, capital market participants have the right to know the implications for the firm value. In particular, the impact of IFRS for intangible assets has received an increasing level of attention among the stakeholders. In Malaysia, the changes of Financial Reporting Standards (FRS) will be effective from 1 January 2006 including FRS 3 (Business Combination) and FRS 138 (Intangible Assets). Therefore, it is imperative for preparers and users of financial statements to be fully aware of these changes in order to achieve full and proper compliance. Consequently, in order to provide significant results this study will use the 2006 and 2007 annual reports. The intangibles reporting reflect the managements of companies in Malaysia are able, or fail to recognise and invest in intangible assets.

Companies must disclose more to attract investors as well as ensure that the financial statement report is prepared in accordance with the accounting standards. This study aims to provide empirical evidence on intangibles or intellectual property reporting among companies in Malaysia. The annual reports of the top 50 most valuable brand companies in Malaysia as reported by Brand Finance Institute on September 2007 will be analysed. These companies are expected to disclose more on intangibles compared to other companies as they are the top 50 brand companies.

## 1.2    BACKGROUND OF THE STUDY

In recent years, the scholarly and business communities have frequently focused on the quantity and quality of information disclosed by companies on their intangibles. Regulating the accounting for intangible asset is arguably the most controversial and difficult area faced by accounting standard setters world-wide (De Mark, 2002; Kanodia et al, 2004). The ongoing debate on accounting treatment of intangible asset is whether to be expensed in the profit and loss account or capitalised in the balance sheet.

In August 2001, the Financial Accounting Standard Board (FASB) has proposed a project on an enhanced disclosure on the intangibles in the financial statements. International Financial Reporting Standard or IFRS 3 Business Combinations was issued in March 2004 and is applicable for business combinations for which the agreement date is on or after 31 March 2004 (IASB, 2004). It requires firms to recognise purchased goodwill as an asset, with no requirement of amortisation. Instead, firms are likely to measure goodwill after initial recognition at cost less accumulated impairment losses.

Intangible assets are of increasing importance for the corporate value creation processes of all kinds of organizations (OECD 1999). The economy has transformed

from a manufacturing base manned by labourers to a service base driven by knowledge workers, thus intellectual capital has emerged as a leading asset class among industrialized countries worldwide.

The term intellectual capital refers generally to the value of a company's intangible assets, which includes those assets traditionally referred to as intellectual property – patents, trademarks, copyrights, etc. – as well as such assets as research & development, production/process information know-how, sales & marketing information, licenses, assembled work force/management, leasehold rights, and other assets without tangible, physical substance. (Cardoza et. al, 2006)

The data provided by S&P 500® has shown an ongoing rise in the U.S equities market. The intangible book value as a percentage of market capitalization of the S&P 500® has approximately doubled every ten years; from an average of 1.6% in 1975, to 3.2% in 1985, to 7.5% in 1995, and to 15.5% in 2005. Meanwhile, tangible book value as a percentage of the value of the S&P 500® has steadily decreased.

Many investors believe that intangible assets have a greater impact on the value of high technology sectors, such as health care and information technology, than on other sectors. Historically, in the labour economy, this was appropriate but not in the knowledge economy. Today, intangible assets have greater impact on all sectors of industries. The labour economy refers to traditional inputs of land, labour and capital which are also known as the physical capital. In knowledge economy the production focuses on intellectual capital which refers to creativity, skills and corporate culture of the firm.

The problem is that such intangible assets of companies are not sufficiently accounted for in financial statements. According to Lev (2003), current financial statements provide little information about intangible assets and even worse the information provided is partial, inconsistent and confusing.

An accounting rule may be followed by some but not by others, thus making it very difficult for users to rely on reported financial information. For example, incurred from the point of "technological feasibility", the software development costs should be capitalized as mandated by Financial Accounting Standard Board (FASB) Statement 86. However, many software companies are not following the rule (Lev, 2003), including profitable companies like Microsoft and Oracle defer profits to the future. Companies that are less profitable tend to capitalize significant amounts of software development.

In addition, there are differences in accounting methods for purchased intangible assets and internally generated intangible assets. The expenditures to build a brand name are immediately expensed and meanwhile the purchase of a brand name is either capitalised directly or while acquiring a company. The inconsistency in application will create significant reporting issues.

A consequence of this reporting issue will deteriorate the information content of key financial statement items. Another indication is that managers are looking for alternative sources and measurements of corporate performance for internal purposes. The mismeasurement of intangible assets will lead to undervaluation of companies that are intangible-intensive.

Therefore to understand the solutions and remedies for the situation, the important issues now are recognition of intangibles, the items that affects balance sheet or income statement and disclosure of intangibles, the footnotes as the provision of information. This means that companies have to disclose more in their financial statements.

## 1.3    MOTIVATIONS OF THE STUDY

The main motivation of this study stems from the increased importance of intangibles assets disclosure and valuation. According to Bergamini and Zambon (2002) financial statements do include information on licenses, trademarks and patents but unlikely to contain data on market research, organisation costs, personnel training cost, customer loyalty and satisfaction, and many other intangibles assets which have no formal place in traditional accounting statements. They also added that the information gap has been narrowed in recent years, but it has not yet been completely eliminated. The disclosure of such items can help the evaluation on the intangibles investment made by companies.

In Malaysia, many of the studies on intellectual capital have focused on the disclosure perspective (for example Bontis et. al, 2000; Goh and Lim, 2004). Another perspective of studies on intellectual capital (IC) focuses on the valuation of IC and its influence on firm's value and performance. Evidence on this perspective in the Malaysian environment is very limited. Shukor et. al (2008) examines the value relevance of reported intangibles among listed firms from year 1990 to 2001 in three different economic periods. Contrary to the theoretical expectation they found that intangibles continuously show negative association with firms' share price throughout three economic periods.

Therefore, this study aims to fill the gap on the studies of intangible assets in Malaysia. This study examine whether the intangible valuation gives impact on financial performance on Malaysia top 50 brand companies. Intangible assets are defined as assets without any physical substance. Business performance with a broader perspective will include financial impact, customer impact, internal business process and learning and growth impact. Financial performance includes the ratios and other measurement which can be obtained through secondary data in the annual reports and

Bloomberg databases. This study will emphasise only on profitability and market valuation of the financial performance. The right sample must be chosen to examine the intangible valuation impact on financial performance. It is expected that choosing the top 50 brand companies will facilitate to achieve the objective of investigating the intangible valuation impact on financial performance of companies in Malaysia as they will disclose more intangible assets. In addition, this study will also address the issue of intangible asset disclosures by the top 50 brand companies in Malaysia.

## 1.4    OBJECTIVES OF THE STUDY

Generally, the objective of this study is to find out the influences of intangible valuation towards the financial performance of top 50 brand companies in Malaysia. In essence, there are three specific objectives in this study. The first objective is to investigate the extent of intangible asset or intellectual capital disclosure in top 50 brand companies in Malaysia. The second objective is to identify the relationship between capitalised intangible asset and market valuation. The third objective is to examine whether there is any relationship between brand value and market valuation. The fourth objective is to examine the relationship between intellectual capital valuation and financial performance in terms of market-to-book ratio and market valuation.

Thus this study formulates three broad research questions:

Research question 1    : What is the extent of intellectual capital disclosure of the

top 50 brand companies in Malaysia for the year 2006 and

2007?

Research question 2    : What is the relationship between capitalised intangible asset

and market valuation?

Research question 3    : What is the relationship between brand value and market

valuation?

Research question 4    : What is the relationship between intellectual capital

valuation and financial performance?

## 1.5    SIGNIFICANCE OF THE STUDY

This study hopes to contribute research findings to companies and investors. The result will highlight the intangible asset performance of the top most valuable brand companies and thus increase other company's awareness of the need to improve their productivity, marketing, product quality in order to increase the intangible asset value. This will then increase the competitiveness between companies in Malaysia by disclosing more information on intangible assets to attract investors. In addition, this study will also look into whether investors use intangible information, specifically intangibles' values in their evaluation of firms' value and performance. This will specifically be tested on the value relevance of intangible values on firms' market values using the Ohlson (1995) model.

## 1.6    ORGANIZATION OF THE CHAPTERS

This research is organized into seven chapters including this chapter.

**Chapter One: Introduction**

This chapter provides an overview of the study, covering the background, motivation, objectives and significance of the study. Intangible asset is the focal point and the new element introduced in the study. The intangible asset concept is explained according to the FRS or IFRS specification.

**Chapter Two: Development of intangible reporting and regulations in Malaysia**

The second chapter defines and provides brief descriptions on the elements of intangible asset in the FRS 38 and IFRS 3. It also covers the categories of intangible asset as outlined by IFRS 3.

**Chapter Three: Literature Review**

This chapter will discuss three main areas in literature review. Firstly, it provides an overview of the development in intangible asset disclosure literatures. Secondly, it highlights several studies done internationally with emphasis on patterns and determinants of intangible asset disclosure. Thirdly, it reviews Malaysian intangible asset disclosure and subsequently identifies any gaps in the literature.

**Chapter Four: Theoretical framework and hypotheses development**

Chapter four explains the theoretical framework and develops the research hypotheses of the study. Specifically, two theories are suggested to explain the reporting practices, namely, stakeholder theory and legitimacy theory. This study formulates nine testable hypotheses to provide evidence on the applicability of both theories.

**Chapter Five: Sample selection and research methods**

This chapter outlines the sample selection, measures of dependent variables and independent variables. This chapter discusses on the research method and explains the procedures involved in the data collection and analysis.

**Chapter Six: Findings and Analysis**

Later in the dissertation, there will be chapter six discussing the findings and analyses of the results in respect of the (1) extent of intangible disclosure (2) relationship

between capitalised intangible and brand value with market valuation, and (3) relationship between intellectual capital valuation and financial performance.

**Chapter Seven: Conclusion and limitation**

Finally, the last chapter concludes and underlines limitations of the study. It also highlights contributions of the study and offers some suggestions for future research.

# CHAPTER TWO

# THE DEVELOPMENT OF INTANGIBLE ASSET REPORTING

# AND REGULATIONS IN MALAYSIA

## 2.1   INTRODUCTION

Accounting techniques were developed to record, classify and summarise economic activities. The evolution of accounting has been influenced by economic structure and the legal systems of the countries. Malaysia experienced an economic boom and underwent rapid development during the late 20th century. In 2007, the economy of Malaysia was the 29th largest economy in the world by purchasing power parity with gross domestic product for 2007 was estimated to be $357.9 billion with a growth rate of 5% to 7% since 2007 (The Edge, 2008). With a GDP per capita standing at US$14,400, it has, from time to time, been considered a newly industrialized country (Bożyk, 2006). The list of selected Asian nations ranked by Growth Domestic Product (GDP) at Purchasing Power Parity (PPP) is shown in Table 2.1 for the year 2007.

Growth in emerging Asia remained strong in the second half of 2007, although with some emerging signs of softness. Growth was led by China, where its real GDP was highest in 2007 (i.e. 11 .4%), followed by India where its real GDP was highest in 2006 (i.e. 9.7%). Robust domestic demand, led by consumption, supported activity in Indonesia, Malaysia, Hong Kong SAR, the Philippines, and Singapore, even while export growth began to show some signs of moderation (IMF, April 2008).

Table 2.1

Comparison of selected Asian countries ranked by Gross Domestic Product (GDP) at Purchasing Power Parity (PPP).

| Countries | Asian Rank | World Rank | GDP (PPP) |
|---|---|---|---|
| China (excludes Hong Kong, Macau) | 1 | 2 | $7,043,000 |
| Japan | 2 | 3 | $4,305,000 |
| India | 3 | 4 | $2,965,000 |
| South Korea | 4 | 14 | $1,206,000 |
| Indonesia | 5 | 16 | $837,800 |
| Iran | 6 | 18 | $753,000 |
| Republic of China (Taiwan) | 7 | 19 | $690,100 |
| Saudi Arabia | 8 | 22 | $572,200 |
| Thailand | 9 | 24 | $519,900 |
| Pakistan | 10 | 26 | $446,100 |
| Malaysia | 11 | 29 | $357,900 |
| Philippines | 12 | 37 | $298,900 |
| Hong Kong, China | 13 | 39 | $293,400 |
| Singapore | 14 | 45 | $222,700 |
| Vietnam | 15 | 46 | $222,500 |

Source: http://en.wikipedia.org/wiki/List_of_Asian_countries_by_GDP_(PPP)

Export growth remained strong in Korea and Thailand, but high fuel prices and political uncertainty weighed on domestic demand in Thailand. In Korea, domestic demand was supported by acceleration in construction and investment activity. Growth in emerging Asia is expected to decelerate but remain robust at about 7.5 percent in 2008 and 7.8 percent in 2009, compared to 9.1 percent in 2007 (Table 2.2). Among the ASEAN‑5 economies, growth is projected to soften by ½ percentage point in 2008, with activity strengthening in Thailand as domestic demand recovers from recent slowness.

Table 2.2.

Selected Asian Economies: Real GDP, Consumer Prices, and Current Account Balance (Annual percent change unless noted otherwise)

| | Real GDP | | | | Consumer Prices[1] | | | | Current Account Balance[2] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2006 | 2007 | 2008 | 2009 | 2006 | 2007 2 Q Q 8 | | 2009 |
| Emerging Asia[3] | 8.9 | 9.1 | 7,5 | 7.8 | 3.7 | 4.8 | 5.5 | 3.9 | 5.7 | 6.5 | 5.3 | 5.2 |
| China | 11.1 | 11.4 | 9.3 | 9.5 | 1.5 | 4.8 | 5.9 | 3.6 | 9.4 | 11.1 | 9.8 | 10 |
| South Asia[4] | 9.1 | 8.6 | 7.5 | 7.7 | 6.5 | 6.9 | 5.9 | 4.7 | -1.4 | -2.1 | -3.4 | -3.6 |
| India | 9.7 | 9.2 | 7.9 | 8.0 | 6.2 | 6.4 | 5.2 | 4.0 | -1.1 | -1.8 | -3.1 | -3.4 |
| Pakistan | 6.9 | 6.4 | 6.0 | 6.7 | 7.9 | 7.8 | 8.5 | 7.5 | -3.9 | -4.9 | -6.9 | -6.1 |
| Bangladesh | 6.4 | 5.6 | 5.5 | 6.5 | 6.5 | 8.4 | 9.3 | 8.1 | 1.2 | 0.5 | -0.5 | -0.7 |
| ASEAN-5 | 5.7 | 6.3 | 5.8 | 6.0 | 8.1 | 4.5 | 6.1 | 4.7 | 4.8 | 4.8 | 2.9 | 1.9 |
| Indonesia | 5.5 | 6,3 | 6.1 | 6.3 | 13.1 | 6,4 | 7.1 | 5.9 | 3.0 | 2.5 | 1.8 | 1.2 |
| Thailand | 5.1 | 4,8 | 5.3 | 5.6 | 4.6 | 2.2 | 3,5 | 2.5 | 1.1 | 6.1 | 3,4 | 1.3 |
| Philippines | 5.4 | 7.3 | 5.8 | 5.8 | 6.2 | 2.8 | 4.4 | 3.8 | 4.5 | 4.4 | 2.1 | 1.0 |
| Malaysia | 5.9 | 6.3 | 5.0 | 5.2 | 3.6 | 2.1 | 2.4 | 2.5 | 16.2 | 14 | 11.7 | 11.1 |
| Vietnam | 8.2 | 8.5 | 7.3 | 7.3 | 7.5 | 8.3 | 16.0 | 10.0 | -0.4 | -9.6 | -13.6 | -11.9 |
| Newly industrialized Asian economies | 5.6 | 5.6 | 4.0 | 4.4 | 1.6 | 2.2 | 3.0 | 2.7 | 5.2 | 6.0 | 4.5 | 4.3 |
| Korea    • | 5.1 | 5.0 | 4.2 | 4.4 | 2.2 | 2.5 | 3.4 | 2.9 | 0.6 | 0.6 | -1.0 | -0.9 |
| Taiwan Province of China | 4.9 | 5.7 | 3.4 | 4.1 | 0.6 | 1.8 | 1.5 | 1.5 | 6.7 | 8.3 | 7.8 | 8,1 |
| Hong Kong SAR | 7.0 | 6,3 | 4.3 | 4.8 | 2.0 | 2,0 | 3.6 | 4.5 | 12.1 | 12.3 | 9.9 | 8.3 |
| Singapore | 8.2 | 7.7 | 4.0 | 4.5 | 1.0 | 2.1 | 4.7 | 2.5 | 21.8 | 24.3 | 20.6 | 18.9 |

[1]Movements in consumer prices are shown as annual averages.          [2]Percent of GDP.

3Consists of d e v e l o p i n g Asia, the newly industrialized Asian e c o n o m i e s , and Mongolia.          [4]inc!udes Maldives, Nepai, and Sri Lanka.

Source: Internationa! Monetary Fund, April 2008.