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Intellectual Capital Disclosures Practices and Intellectual Capital Performance in Saudi Arabia Financial Institution

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Abstract: *This study has two main objectives: (1) to reports the result of an empirical examination of Saudi Banking sector annual reporting of Intellectual Capital (IC) in terms of content and (2) to measure intellectual capital performance of Saudi Banking sector using efficiency coefficient called VAIC™ developed by Ante Pulic. The communication of IC was reviewed from three angles namely: human capital, external capital and internal capital. Content analysis was used to examine ICD practice in the annual report of 12 commercial banks listed on Saudi Arabia (Tadawul) Stock Exchange in 2014. The level of efficiency is measured using VAIC indicator which identifies the bank with efficiencies in utilizing the human capital. Ranking of banks according to VAIC then are compared with the traditional way of ranking, to see if the banks with good performance according to traditional ways are also efficient in utilizing capitals.The finding shows that all Saudi banks listed in Tadawul Stock Exchange disclosed intellectual capital information in their 2014 annual report. Intellectual capital items mostly were disclosed in discursive form and throughout the annual report. In terms of average percentage occurrence per intellectual capital for the three categories, human and external capital were closely matched at about 38% and 35% respectively, while internal capital was significantly lower at 27%. The results for VAIC efficiency show that the banks have relatively higher human capital efficiency than structural and capital efficiency. Samba Financial Group, Saidi British bank and Banque Saudi Fransi were the top three efficient banks based on the VAIC assessment; in contrast the least efficient bank is Bank Al Jazira which has only 1.772 for VAIC efficiency coefficient. The present study only examined the banks' 2014 annual report. Since only the Saudi banking sector is used in the present research, the generalization of the findings to the other sectors may be questioned*

Keyword: Intellectual capital disclosure, intellectual capital performance, financial institution, Saudi Arabia

Introduction

During the last two decades, Intellectual capital (IC) resources such as human capital and customer relations becomes the new driver for corporate development and companies which focus on their employee knowledge, innovation, and skills are developing more than those

depending on their fiscal assets. Machlup (1962) was the first to coin the term "intellectual capital" and used it to emphasize the importance of general knowledge as essential to growth and development. According to Stewart (1997) Intellectual Capital consist of knowledge, information, intellectual property, and experience that can be put to use to create wealth. In the new economic era, Intellectual capital resources becomes a key factor in sustaining competitive advantage and creating values of the firm (Shih et al, 2010) because Intellectual capital is difficult to imitate and substitute (Reed et al, 2006). Guthrie (2000) further defines Intellectual Capital as the value of a firm's intangible assets. The Organization for Economic Cooperation and development (OECD) (2000) define Intellectual Capital as the economic value of two categories of intangible assets of a firm: organizational capital and human capital. Other researchers, classify Intellectual Capital into three components: human capital, structural capital and relational capital (Abeysekera & Guthrie, 2005; Aledwan, 2014: Wee and Chua, 2015). Although Intellectual Capital has been defined in many different ways, the researchers and practitioners do not have consensus on it.

In Saudi Arabia, the influence of politics and government bureaucracy is the factor that affects the adoption of innovations by organizations (Wheeler, 2005). In many cases politics determines the adoption of new technologies in the country, regardless of commercial needs. In the last three decades the Kingdom of Saudi Arabia has witnessed significant developments in all fields including the business sectors. Saudi Arabia government realizes that in the new economic era, intellectual capital assets are recognized as the key driver behind wealth creation. Minister of Commerce and Industry, Abdullah Alireza, said that, "Saudi Arabia is moving away from being a gas station of the world toward a sophisticated laboratory of excellence, innovation and knowledge." He also added that, "Our focus is on building intellectual capital, a knowledge-based economy and a continuation of our industrialization process," (Rasooldeen, 2011). Bontis (2004) points out that there is also great interest in intellectual capital development in the Arab region as well. Saudi Arabia economic development path is complicated and many factors affect the final outcome, whether they are in education reform, economic restructuring or globalization. The key issues that remain facing KSA include continuing to diversify the economic base and reduce country`s heavy dependency on hydrocarbons, managing expectations based on narrow revenue base, and empowering the private sector to become the engine of growth through meaningful Saudi job creation and experts as well as meeting the kingdom`s new international obligations since accession to the World Trade Organization in 2005 (Ramady, 2010).

Even though Saudi Arabian government realizes the important of intellectual Capital, little is known and many questions remain unanswered about intellectual capital disclosure and intellectual capital performance in Saudi Arabia. To the best of the researcher's knowledge no empirical evidence exists that allow a conclusive determination to be made of what the current intellectual disclosure practices is in Saudi Arabia and how is its performance. As such, this study will be an exploratory in nature which intends to fill the gap to find the intellectual capital practices and to measure intellectual capital performance in Saudi Arabia. Therefore this paper aims to show that Intellectual capital disclosure is a key factor of creating firm`s value by reflecting the disclosing content of intellectual capital in Saudi Arabia. As such, the objectives of this study are:

- To explore the current practices of Intellectual Capital disclosure (ICD) by the commercial banks in Saudi Arabia.

- To investigate the content category disclosure of Intellectual Capital by the commercial banks in Saudi Arabia
- To measure Intellectual Capital using the efficiency coefficient (VAIC™)

The remainder of this paper is organized as follows. The next topic provides a review of the literature. This is followed by a description of the research methods, including data collection and analysis, used in the study. The results and findings of the study are then presented and discussed. Summary and conclusions, including possible limitations and areas for future research are presented in the final topic.

Literature review

To acknowledge the importance of intellectual capital, many researches into the general topic of intellectual capital began in the 1990s. The intellectual capital researches mainly concerned with raising awareness about the existence and value of intangible assets within organizations and about developing classification models for intellectual capital (Hall, 1989; Itami, 1991; Roos et al., 1997; Stewart, 1997; Brooking, 1996). The focus is on adding a value on intellectual capital intangibles. Generally, three approaches to measure intellectual capital have been suggested. One approach is to employ existing value-based measures. It is suggested that the value of intellectual assets is the difference between the market value of the firm and its book value. A second approach is to measure 'hidden' intellectual assets which were put forward by a Swedish firm, Skandia. In its 1994 annual report, the Skandia Navigator was presented which identified and quantified critical success factors in four key dimensions of the business. The third approach is to use an intellectual capital index to provide a measure of the efficiency of intellectual assets (Roos et al., 1997). This approach starts with identifying key measures of success of an individual firm and weighted (according to importance) to provide a single summary index.

Later on, literatures shifted to focus on the measurement of intellectual capital with the creation of frameworks, indices and guidelines to support the initial concepts of having different reasons as to why organizations should measure their intellectual capital (Sveiby, 1997; Mouritsen et al., 2001; Bontis et al., 1999; (DATI) Danish Agency of Trade and Industry, 2000; Lev, 2001; Meritum, 2002). The study focuses on different rationales for the measurement of intellectual capital. Guthrie and Petty (2000) examined Australian annual reporting of intellectual capital of the top 20 Australian listed companies from various industries in 1998. The study primarily aim was to assess the extent to which large organizations were publicly reporting their intellectual capital. This study investigated the amount and type of information being reported and how they record, measure and manage. The content analysis method was used to understand the ICD magnitude. A framework developed by Sveiby (1997) was used, which categorizes intellectual capital according to organization's internal capital, external capital, or human capital within an organization. For the purposes of the analysis the researchers modified the professional intellectual capital framework to achieve a better convergence with items likely to be reported by Australian companies. Following these changes, 24 out of 30 items remained (9 related to internal capital, 9 to external capital, and 6 to human capital). Brennen (2001) analyzed the reporting of intellectual capital using a content analysis of annual report of 11 knowledge-based companies listed on Irish Stock Market in 1999. Measurement of intellectual capital again involved a total of 24 items across three intellectual capital categories. Abeysekera and Guthrie (2005) empirically examined the annual reports of the top 30 different firms listed on the

Colombo Stock Exchange for the years 1998 and 1999. The researchers classified 45 intellectual capital items by external capital, human capital and internal capital categories. Haji and Mubaraq (2014) empirically investigated the trends of ICD practices of the Nigerian banking sector over a period of four years (2006-2009). A self-constructed ICD checklist was used to measure the extent of IC information disclosed in the annual reports to suit the Nigerian context. The final disclosure checklist contained 44 items of which 10 items were internal capital, 16 items were external capital and the remaining 18 items represented human capital

Recently, literatures started to link intellectual capital with performances. Some studies focus on intellectual capital performances using the efficiency coefficient, called Value Added Intellectual Coefficiency (VAIC) which was developed by Ante Pulic. Pulic (2001, 2002) discusses the value creation efficiency analysis of 20 banks in the Croation economy for a period of five years and comes out with a VAIC™ ranking. The efficiency of the banks is measured using the performance of the capital employed and the intellectual capital using VAIC™ as a tool of measurement. In 2005, a study was carried out by Goh to examine the Malaysian commercial banks intellectual capital performance using the VAIC model for three years period (2001-2003). This study aims to compare the Malaysian local commercial bank and foreign bank efficiency in term of utilizing the human capital. Mavridis (2004) conducted a study for 140 Japanese banks intellectual capital performance and compared the result with Greece and Austrian countries. This study adopted the VAIC model with some modification to suit the Japanese banking sector environment. This study focus on the actual status of human capital and physical capital and its predictive, discriminative and integrative impact on the intellectual added value based performance situation. Kamath (2007) estimate and analyze the VAIC™ foe measuring the value-based performance of the Indian banking sector for a period of five years from 2002 to 2004.

METHODOLOGY

Sample

This study uses a content analysis approach to examine the information cited by all 12 commercial banks listed in Saudi Stock Exchange (Tadawul). Data are collected from the latest annual reports (2014) to explore the current practices on ICD and to measure intellectual performance. The banking sector was chosen for several reasons. First, commercial banks in Saudi Arabia are the most active sector in the economy and they play an active and dynamic role in the economic development. Saudi incorporated bank assets account almost 75.6% of the 2014 GDP. In term of market capitalization, the banking sector has increased by 35.20% in 2014, and the sector shares 28% of the market distribution as shown in Figure 3.1 which is the largest among other sectors (SAMA, 2015). Another reason for choosing the banking sector is because the banking sector has experienced a dynamic and competitive environment due to globalization of economies and has grown as a knowledge concentrated sector (Mavridis, 2004). On top of that, the banking sector is a model sector for research on IC issues because of the basic nature of the banking business which is a knowledge intensive sector and is highly dependent on intellectual capital to remain competitive (El-Bannany, 2008). This is because intellectual capital determines service quality, product differentiation, and value added services which in turn affects the performance of the banks (Goh, 2005). Equally important, banks operate in a highly regulated environment under great scrutiny to perform. So banks are required to produce annual

reports of their performance to regulators and stakeholders which make them publicly available for analysis.

ICD Practices

In order to investigate the ICD practices in Saudi Arabia banking sector, this study collects the intellectual capital information from banks' annual reports. The intellectual capital information is based on Sveiby's intellectual capital framework which categorized intellectual capital into three categories, namely, human capital, internal capital and external capital. Human capital is closely associated with the employees and it refers to their knowledge, competencies, experiences and know-how, their combined skills and innovativeness necessary to solve customer needs and problems (Edvinsson and Malone, 1997; Sveiby, 1997). Internal capital concerns with the mechanisms and structures of the organization that support employees in their quest for performance (Bontis et al., 1999). It comprises knowledge resources embedded in databases, systems and processes that provide the environment to encourage employees to create and leverage knowledge within the organization. External capital refers to the knowledge embedded in the relationships that the organization has developed internally and externally (Bontis et al., 1999). The most important external capital is customers, suppliers, business partners, shareholders and other stakeholders such as the local community (Sveiby, 2001).

This study emulate Abeysekera and Guthrie (2005) by dividing the human capital category into 25 intellectual capital items, the internal capital into 10 intellectual capital items, and external capital category into 10 intellectual capital.. Because the data in the coding framework is too descriptive, the IC items were clustered into several IC sub-categories. The IC items in the human capital category were clustered into seven sub-categories: (1) *Training and development* comprises of know-how, vocational qualifications, career development and training programs; (2) *Entrepreneurial skills*; (3) *Equity issues* comprises of equity issues relating to race, gender, religion and disability; (4) *Employee safety;* (5) *Employee relations* comprises of union activity, employees being thanked, employees being featured and employee involvement in the community; (6) *Employee welfare* include employee and executive compensation plans, employee benefits, and employee share and option ownership plans; (7) *Employee-related measurements* comprises of value-added by employees and executives, employee numbers, professional experience, education levels, expert seniority and age of employees (Subbarao and Zeghal, 1997). The internal category was clustered into five IC sub-categories: (1) *Processes* which includes both management and technological processes; (2) *Systems* comprises of both information systems and networking systems; (3) *Philosophy and culture*; (4) *Intellectual property* which includes patents, copyrights and trademarks; and (5) *Financial relations* comprise of favorable and/or unfavorable financial relations with other institutions. The external category is clustered into five IC sub-categories: (1) *Brand building* including brands, customer satisfaction, and quality standards; (2) *Corporate image building* including company name and favorable contracts; (3) *Business partnering* comprises of business collaboration, licensing agreements and franchising agreements; (4) *Distribution channels* refers to distribution channels held by the firm; and (5) *Market share* refers to the market share held by the firm.

The intellectual capital information collected was coded into the coding sheet. The study employed semantic content analysis whose purposes is to count pre-determined intellectual capital items referred to in the annual report (Andren,1980). Since the objective of the study is to

investigate the disclosure of any information about intellectual capital, no attempt was made to classify the disclosed intellectual capital categories as mandatory or voluntary. This study used a numerical coding system that was used by Guthrie and Petty (2000) consisting of the units '0', '1', '2', '3'. A value of '0' was assigned if the item did not appear. A value of '1' denoted that the item appeared in a discursive (qualitative) form. A value of '2' was assigned if the item was expressed in numerical terms and a value of '3' if the item was quantified in currency terms. If disclosure of the same item was repeated in the annual report, it was recorded only once.

VAIC measurement

In order to measure the level of efficiency, this study used VAIC indicator which identifies the bank with efficiencies in utilizing the human capital. Ranking of banks according to VAIC then are compared with the traditional way of ranking, to see if the banks with good performance according to traditional ways are also efficient in utilizing capitals. The VAIC method used in this study was developed by Pulic (2002a, b). The formulas are as follows:

- Output = Sales and other revenue
- Input = cost of sales and other expenses
- Value added (VA) = output – input
- HC = Human capital (staff expense)
- CA = Available fund (equity, net profit)
- SC = VA – HC
- HCE = VA/HC (indicator of human capital efficiency)
- CEE = VA/CA (indicator of capital employed efficiency)
- VAIC = HCE+CEE+SCE (Value added intellectual coefficient)

The intellectual property is intangible; therefore, it is almost impossible to measure it. Thus, results of applied intellectual capital are used as a surrogate measure. This indicates that the amount of value added and the efficiency in utilizing the intellectual capital can be quantitatively measured using the above formula. The efficiency levels to be calculated are HCE, CEE and SCE and the sum of these efficiencies is VAIC. If VAIC is higher, it indicates that the better the efficiency level of the firm in term of performance indicator and this in long term create more value to the firm. When the VAIC falls, the firm efficiency will deteriorate and value is destroyed.

RESEARCH FINDINGS AND DISCUSSION

Table 1 and Figure 1.1 summarize the result for ICD disclosure practices in Saudi Arabia banking industry. The finding shows that all Saudi banks listed in (Tadawul) Stock Exchange disclosed intellectual capital information in their 2014 annual report. This indicates the existence and the growing awareness toward ICD across Saudi commercial banks because the banking sector is considered as one of the "knowledge-intensive" sectors (El-Bannany, 2008) and can be expected to have higher intellectual capital disclosures (Ordonez de Pablos, 2003; Mention, 2011). Based on the result, it seems that the voluntary disclosure of IC by commercial banks in Saudi Arabia is

a method that organizations used to respond to the society as suggested by the legitimacy theory. Human and external capital categories are closely matched at about 38% and 35% respectively, while internal capital is significantly lower at 27%. There is clearly more focus on human capital which is not surprising since employees are the value creation for banking sector. The second highest category disclosure for Saudi banks is on external capital. This is true considering that many of the banks compete with each other to attract their customers, brands, business collaborations and distribution channels.

Higher human capital disclosure in Saudi banking sector could be a result of the government's five-year development plan. The Eighth (2005-2009) and Ninth (2010-2014) development plans where the government's focus shifted from developing the country infrastructure towards the development of a knowledge-based economy to enhance competition and create jobs opportunities for the Saudi population. The result for this study is consistent with the Nigerian and the listed banks in global stock exchange (Haji and Mubaraq, 2012; Wee and Chua, 2015) which recorded higher disclosure in human capital disclosures in terms of training and development. This is true due to the increased regulations by government regarding economic changes and unemployment. According to Haji and Mubaraq (2012) given the implications of the recent financial crises on the local communities, banks would thus strive to report higher amount of human capital disclosure in attempt to show their involvement with the staff as such discloser might help the banks legitimize their future existence and build better corporate image.

As for the specific disclosure for internal capital, the result shows that Saudi Arabian banks disclosed more information related to employee related measures, employee relation, employee welfare, and employee training and development. The result of this study is similar to the Nigerian and the listed banks in global stock exchange (Haji and Mubaraq, 2012; Wee and Chua, 2015) which recorded higher disclosure in human capital disclosures in terms of training and development. This is true due to the increased regulations by government regarding economic changes and unemployment. According to Haji and Mubaraq (2012), banks would thus strive to report higher amount of human capital disclosure as such discloser might help the banks legitimize their future existence and build a better corporate image. The specific disclosure result for the internal capital show that Saudi banks have higher tendency to disclose internal capital information in discursive form. Looking at ICD within internal capital, the result clearly shows that management process (such as risk management and banks operations), philosophy & culture are the most disclosed items in the annual report. This result is in line with previous banking sector studies such as Haji and Mubaraq (2012), and Wee and Chua (2015) which showed higher disclosure of internal capital in management process and culture. That shows how companies trying to sustain high performance between and within employees to reach competitive advantage. Comparing all figures for external capital disclosure, the results show that Saudi banks had less disclosure of market share information in their annual report. On the contrary, Saudi banks disclosed more external capital in the form of business partnering and brand building. This result shows how customers, brands, and external stakeholders is an important factor for competing in this economy while raising the company's image through people minds.

Table 1: Frequency of Reporting Intellectual Capital Items

INTELLACTUAL CAPITAL		TOTAL (12 BANKS)	PERCENTAGE
HUMAN CAPITAL	TRAINING & DEVELOPMENT (knowhow, vocational qualifications, career development, training programs)	12	100%
	ENTREPRENURIAL SKILLS	1	8%
	EQUITY ISSUES (race, gender, religion, disability issues)	10	83%
	EMPLOYEE SAFETY	5	42%
	EMPLOYEE RELATIONS (union activity, employee thanked, employees featured in annual report, employee involvement with the community)	11	92%
	EMPLOYEE WELFARE (employee & compensation plans, employee benefits, employee share & option)	12	100%
	EMPLOYEE RELATED MEASUREMENTES (value added statements, employee numbers, professional experience, education level, expert seniority, age of employees)	12	100%
INTERNAL CAPITAL	PROCESS (management & technological process)	12	100%
	SYSTEM (information system & networking system)	12	100%
	PHILOSOPHY & CULTURE	12	100%
	INTELLECUAL PROPERTY	7	58%
	FINANCIAL RELATIONS	12	100%
EXTERNAL CAPITAL	BRAND BUILDING (brands, customer satisfaction, quality standards)	12	100%
	CORPORATE IMAGE BUILDINGS (company names, favorable contracts)	11	92%
	BUSINESS PARTNERING (business collaborations, licensing agreements, franchising agreements)	12	100%
	DITRIBUTION CHANNELS	12	100%
	MARKET SHARE	7	58%

Figure 1

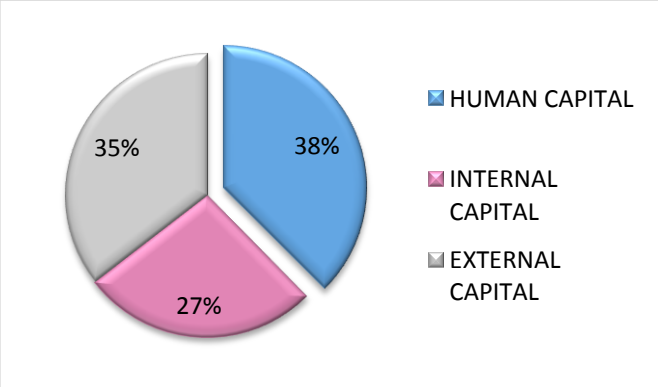

Table 2 shows the results of banks efficiency in utilizing the human capital. Samba Financial Group has the highest HCE of 3.977, followed by The Saudi British Bank of 3.7 and Banque Saudi Fransi of 3.309. Bank Al Jazira has the lowest HCE of 0.787, CEE of 0.084 and SCE of 0.9. A HCE of 3.977 means that for every SAR1 invested, Samba Financial Group created SAR

3.977 from its human capital. Samba Financial Group also has the highest CEE, and National Commercial Bank has the highest SCE. As a whole, banks in Saudi Arabia have relatively high HCE compared to CEE and SCE. With regards to VAIC ranking, Samba Financial Group has the highest VAIC of 4.912, followed by The Saudi British Bank (4.701), Banque Saudi Fransi (4.287) and Saudi Hollandi Bank (4.184). With VAIC of 4.912, for every SAR1 invested by Samba Financial Group, SAR 4.912 is generated. The least efficient bank is Bank Al Jazira with VAIC of 1.772.

Table 2: Result of the Analysis Using VAIC Rank for the bank in Saudi Arabia

VAIC Rank	Bank Name	VAIC	HCE	CEE	SCE	VA	VA Rank
1	Samba Financial Group	4.912	3.977	0.114	0.82	5,005,078	3
2	The Saudi British Bank	4.701	3.700	0.140	0.86	4,266,061	5
3	Banque Saudi Fransi	4.287	3.309	0.117	0.86	3,515,542	6
4	Saudi Hollandi Bank	4.184	3.181	0.122	0.88	1,825,349	8
5	Riyad Bank	3.863	2.925	0.107	0.83	4,305,687	4
6	Al Rajhi Bank	3.719	2.719	0.140	0.86	6,836,172	2
7	National Commercial Bank	3.702	2.651	0.160	0.89	8,655,150	1
8	The Saudi Investment Bank	3.525	2.553	0.102	0.87	1,356,964	9
9	Arab National Bank	3.299	2.307	0.121	0.87	2,849,571	7
10	Alinma Bank	2.855	1.998	0.066	0.79	1,273,229	10
11	Bank Al Bilad	2.162	1.163	0.127	0.87	864,029	11
12	Bank Al Jazira	1.772	0.787	0.084	0.9	568,628	12
	Average	3.582					

Table 3 shows the result of comparing the VAIC and the traditional ranking based on stockholders equity. Ranking on these two systems shows that National commercial bank has the highest stockholder equity but this bank is rank at number 7th for the VAIC rank. This may indicate that this bank did not utilise the stockholders equity as efficient as Samba Financial Group. The results also show that Al Rajhi bank and Riyad bank have a consistent ranking based on these two systems.

Table 3: Frequency of Reporting Intellectual Capital Items

Bank Name	VAIC	Stockholder Equity Rank
Samba Financial Group	4.912	3
The Saudi British Bank	4.701	6
Banque Saudi Fransi	4.287	5
Saudi Hollandi Bank	4.184	10
Riyad Bank	3.863	4
Al Rajhi Bank	3.719	2
National Commercial Bank	3.702	1
The Saudi Investment Bank	3.525	9

Arab National Bank	3.299	7
Alinma Bank	2.855	8
Bank AlBilad	2.162	12
Bank AlJazira	1.772	11
Average	3.582	

Conclusion

The finding indicates that banks in Saudi Arabia disclose intellectual capital in their annual reports. This clearly shows awareness among Saudi banking sector of the important of ICD in corporate value creation and shareholder relation and legitimacy. The results show that Saudi banks disclose more information discursively in term of human capital followed by external capital, and lastly disclosed the internal capital items with least percentage. In addition, the result for measuring intellectual capital performance shows that Samba Financial group have the highest VAIC efficiency coefficient of 4.912 and Bank Al Jazira have the lowest VAIC efficiency coefficient of 1.772. Overall, the present study significantly contributes to the literature of ICD in several ways. First, to the best of the researcher knowledge, there is no study examining the disclosure practices of intellectual capital in Saudi Arabia. Consequently, this study is the first to explore this issue. The researcher hopes that this study will contribute to the limited literature on intellectual capital in MENA in general and in Saudi Arabia in particular. Findings from this study will help Saudi companies to and be careful when investing in intellectual capital; understanding the benefits of ICD; and implementing rules and regulation for such a disclosure. The result of this study will be of interest to the researchers and academic community due to a lack of formal research body addressing the subject of ICD in Saudi Arabia and therefore this study will provide substantial information about this area in the markets of Saudi Arabia. The present study is subject to several limitations, suggesting opportunities for further research. First, the present study only examined the banks' 2014 annual report. Future research should use a multiple research periods in order to examine the trend of ICD in Saudi Arabian banks taking into consideration the constant change of annual reports. Since only the Saudi banking sector is used in the present research, the generalization of the findings to the other sectors may be questioned. It is suggested for further research to study the other sectors in Saudi Arabia in order to compare and contrast between different sectors as well as countries, and create a framework that can be safely generalized. Finally, due to the absence of a fully agreed research framework comparison of intellectual capital category may vary. So, agreed framework and methodology for analysis would be great help to researchers.

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