

## How do Intellectual Capital and Islamic Values Relate to Small Business Performance? A Conceptual Framework

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### ABSTRACT

There is a plethora of studies exploring the contributing factors to small business success based on the institution, financing and loan repayment, yet paying little attention to the intangible assets and Islamic values of the enterprises. Thus, these studies were seen inadequate to educate small entrepreneurs on how to attain competitive advantages and growth, eventually to cope with the global world. Only firms with ability in all aspects of competitive edges will be able to gain advantages over their rivals. Hence, the creation and management of intangible assets such as intellectual capital and Islamic values are vital to overcome firm competitiveness and performance issues. What components of intellectual capital that should be emphasized to gain a competitive edge and profitability? Do Islamic values predict the subsequent performance of small firms? Building on previous research, this paper may provide a deeper understanding of the relationships between intellectual capital, Islamic values and firm performance. Specifically, a conceptual model is developed linking different dimensions of intellectual capital and Islamic values to small business performance. This is then used to provide insights into how these 2 factors affect firm performance.

**KEYWORDS:** Entrepreneur, Intellectual Capital, Islamic Values, Business Performance.

### INTRODUCTION

Small and medium enterprises (SMEs) are important for Malaysia's future growth because they can deliver a robust underpinning for the development of new industries along with reinforcing existing ones. In order to achieve sustainable economic growth, Malaysia attempts to develop various and competitive SMEs. In [62] mentions that in the highlights of globalization, competitive approaches are pertinent to firms regardless of their size. Thus, SMEs particularly micro enterprises have to strive for prospects in the global marketplace [22].

Undeniably, studies prove that entrepreneurship is a crucial indicator of economic growth [11, 10]. SMEs have the ability to change social conditions, employment and income status, exploring the entrepreneurs' skills, promoting political stability, augmenting innovative and competitive power, uplifting sustainable livelihoods, creating economic sustainability and eradicating poverty [68, 43, 53].

Acting as a vital contributor to development in Malaysia, SMEs have contributed 33.1% of the national Gross Domestic Product (GDP), about 57.7% of employment and 19% for exports [21]. By the year 2020, SMEs are expected to contribute 41% to GDP, almost 62% of employment and 25% for exports [78]. About 97.3% (645,136) business establishments in the country are SMEs and 77% out of those figures is micro enterprises [22]. Nevertheless, the world economy is changing towards a knowledge-based economy in which information is easily accessible and without any limitations. SMEs' ability to manage knowledge efficiently turn out to be an essential avenue for success [82]. This statement is in line with [48] stating that the owner-managers' characteristics, knowledge, experience and expertise are the contributors of the SMEs' success. Although most studies highlight on SMEs' facing impediments of lacking tangible resources, physical and financial principal in order to be successful, few researchers focus on the real SMEs' encounter that is to establish the intangible assets entrenched in the organization as entrepreneurial resources [27]. Furthermore, in order to be competitive, SMEs should consider emphasis on the internal resources, external surroundings and the entrepreneurs' values [48].

Islam is a comprehensive way of life (ad-Din), thus Muslim entrepreneurs' values must be in accordance with Islamic teaching that is ruled by Al-Qur'an and Sunnah. Otherwise, Muslim entrepreneur will choose Islamic institutions (for a business loan application) not because of the encouragement of faith to submit to Allah SWT but merely by following the recent trend that Muslims should go for something Islamic [4]. In fact, business undertakings of Muslim entrepreneurs should be targeted on attaining better performance and competitive edge as Allah SWT commanded in which all productions are stringently to the permissible (halal), refraining from the prohibited (haram) and Shariah compliance [63]. Besides that, Islamic ethical behaviors like honesty and justice are emphasized [84]. Islam encourages Muslims to work and not just rely on fate. Islamic

values and spirit provide much help in instilling the qualities of dynamism in Muslims [71] and perhaps improving dynamic capabilities in global competitiveness orientation.

Managing intangible assets or intellectual capital (such as patents and other intellectual property, partnerships, suppliers, alliances, talents, knowledge, innovation, leadership, reputation and values) are the indispensable substance of competitive advantage and firm profitability [9, 74, 1, 38]. In market turbulence and globalization, the competitive challenge involves the capability of firms to create and manage intangible assets specifically emphasize the importance of intellectual capital in ensuring that companies can compete in the ever growing economy. Generally, Muslims small entrepreneurs comprehend the good effects of Islamic values to their lives but to what extent those standards influence their business performance to become more competitive might not commonly clarified. Thus, this study provides an understanding into the influence of intellectual capital and Islamic values on small business performance. An alternative theoretical perspective which focusing on the internal resources of small enterprises that acts as the competitive advantages. Intrinsically, small enterprises will be able to become the main players in the economy instead of discerning about their physical and financial incapacities [48].

This article is divided into 8 sections. The first section stresses on intellectual capital and its components, second is Islamic values and its dimensions, third is small business performance, fourth is intellectual capital and small business performance, fifth is Islamic values and small business performance, sixth is the relationships between intellectual capital, Islamic values and small business performance, seventh is implications for theory and research and last is conclusion.

## **INTELLECTUAL CAPITAL AND ITS COMPONENTS**

### **Intellectual Capital**

Intellectual capital refers to the collection of intangible resources [17] or concealed assets that is not visible on the financial statement [26]. Small enterprises should be focusing on intellectual capital as it is an underpinning factor to form a fundamental competence for future success. Likewise, new enterprises have to put intangible factors into consideration when preparing a business plan to convince potential sources of funding [24]. Most researches divide intellectual capital into three basic elements namely human capital, organizational capital and customer (relational) capital [12, 47, 57, 15, 26]. Consequently, small firms should capitalize its assets in the above parameters in order to acquire high competitiveness in business. As stated by [49], the dimensions of intellectual capital could provide a more vivid comprehension of the concept and its influence on business achievement.

### **Human Capital**

Human capital is defined as workers' knowledge in the company [16]. In [64] describes the workers acquire the intellectual capital of the competency, attitude and sensitivity. Although the workers' intellectual and knowledge are considered as the most important asset of the company, organizations cannot have it. In [46] states that human capital is the skill, intelligence, and expertise. In essence, human capital is the ability of intellectual in the organization.

### **Organizational Capital**

Organizational capital is the infrastructure support in the organization that allows human capital to work in an organization. It includes work procedures, systems, processes, programs and philosophies that allow organizations to function in providing goods and services [39]. It also involves continuous learning and application of knowledge that is done every day [42]. In [15] argues that if organizations do not have adequate procedures and systems, intellectual capital will not reach its peak. Another important feature is the ability of an organization to develop, manage and calculate intellectual capital in any situation [15].

### **Relational Capital**

Relational capital refers to the organization's relationships with external parties such as suppliers, partners, customers and community. This relationship generates the perception of stakeholders in the organization and facilitates the exchange of knowledge between the two parties [15]. Relational capital provides a multiplier effect in the creation of value by linking human capital and organizational stakeholders. For small firms, relational capital is normally through their personal networks [3] that help them to recognize business opportunities [14].

## **ISLAMIC VALUES AND ITS DIMENSIONS**

Islamic values refer to values in Islamic teachings which need to be practiced by entrepreneurs and incorporated in their entrepreneurial activities [36]. In [2] insists that akhlaq (moral values) is values that

entrenched in a person's soul, thus his or her deed happens naturally. Muslim entrepreneurs should base the intention of doing entrepreneurial activities for the sake of realizing Allah's pleasure and achieving the betterment in this world and hereafter. Islamic values that should be practiced by Muslim entrepreneurs have been discussed by Muslim scholars [35, 60, 79, 28]. Those studies have outlined a number of characteristics that are possessed by Muslim entrepreneurs. Somehow, the traits are derived from *taqwa* (piety) and *'ibadah* (worship) to Allah SWT that comprise of the execution of obligatory and voluntary worship, as well as *fardhu ain* (personal) and *fardhu kifayah* (community). In [56] concluded that besides *taqwa* and *ibadah*, Islamic values should also consist of prioritizing the lawful, not being wasteful, practicing high moral, trustworthy, participated in the welfare, knowledgeable and caring for the society and the environment. Hence, the dimensions of Islamic values can be implied as:

- a. *Taqwa* to Allah SWT-have the right intentions based on Islamic principles and to practice mandatory and voluntary worship both of *fardhu ain* and *fardhu kifayah*.
- b. Worship to Allah SWT-put priority on the worship to Allah such a prayer, fasting on Ramadan, *hajj* and *umrah* (pilgrimage), charity, *zakat* (alms), *sunat* prayers and etc. rather than other works.
- c. Halal-opt for a halal source, pure and clean; practice a halal procedures.
- d. Not being wasteful-utilize all the resources efficiently.
- e. Espousing the high moral-abstain from any activities that are prohibited by Islam as usury, bribery, embezzlement, adultery, stealing, etc.
- f. Trustworthy - honesty, trust, keeping promises, punctuality, etc.
- g. Concerned about the welfare-assist each other, especially the poor and needy.
- h. Knowledgeable-constantly seek for the new knowledge.
- i. Caring for the society and the environment-the production is safe and do not harm the society and the environment.

#### **SMALL BUSINESS PERFORMANCE**

Small business performance is based on the success of small enterprises, basically the perception of the company that will be measured subjectively. Such a measurement has been widely employed by previous studies [30, 73]. Most of the items used in the instrument are referring to the items used by [41, 29]. Entrepreneurs will be asked about their satisfaction with the outcome of the sales, profit, business stability, growth, an increase in the number of employees, customer satisfaction and net asset value of the business. All information will be measured using a Likert scale from 1 = "very dissatisfied" to 5 = "very satisfied". As a subjective measurement of success is often prone to errors [80], its authenticity will be verified by adding a number of items in the questionnaires. Entrepreneurs are required to answer objectively the questions about the performance of the company-including the profits and sales per month (both are in Malaysian Ringgit).

#### **INTELLECTUAL CAPITAL AND SMALL BUSINESS PERFORMANCE**

The different components of intellectual capital provide an in-depth understanding on the importance of intellectual capital as intangible assets for firm competitive advantage. In [58] indicated a robust positive correlation between intellectual capital and firm performance. But, each construct (human capital, structural capital or relational capital) has a different weightage of impact on business performance and depends on the type of company and industry [70]. A research finding by [15] found that human capital is impractical if there is no support from organizational capital.

Few studies have been able to explore the effect of mutual dependence between human capital and business profitability [69, 51, 33, 44]. In [66] explains higher value of human capital leads to better small business performance of start-up firms. Whereas, in the research findings of [40], human capital appeared to have an insignificant relationship with organizational performance in Pakistan SMEs. However, in [55] stated that micro enterprise profitability is related positively and significantly to human capital and business assets but the association is negative and insignificant for female and countryside entrepreneurs. According to [75], empirical research on the relationship between human capital and survival is limited as the composition of human capital can be molded by demand and influenced by social and organizational context.

Organizational capital refers to the total of company abilities possessed by the business that facilitates it in fulfilling market requirements [83]. However, in [45] stated that managers are the ones responsible to construct organization capital. According to [74], by increasing organizational capital, the firm's profitability will be elevated. Similar to the findings of [9], organizational capital is positively related to firm performance. Using capitalizing selling, general and administrative expenses, an income statement item as organizational capital proxies, in [77] study the influence of organizational capital on European firms' performance. The findings indicate a positive significant association between organizational capital and firm performance.

For better business performance, the firm should possess relational capital which comprises of market relationships, power relationships and collaborations among customarily similar firms, foundations and people that have a robust sense of cooperation [19]. For small firms, relational capital is informal in nature that is more on an individual basis such as family, friends and contacts [31]. Relational capital is a vital asset for SMEs because it is the avenue to negotiate with others such as suppliers, partners, customers and community and make concerted agreements [79]. As mentioned by [13], companies converging on the values of human relations as capital resources particularly relational capital will have a competitive advantage. In [72] claims cognitive social capital has a sturdy determinant of the collaboration among organizations. Based on the arguments above, the following propositions are suggested:

- H1: Human capital is positively related to small business performance.
- H2: Organizational capital is positively related to small business performance.
- H3: Relational capital is positively related to small business performance.

**ISLAMIC VALUES AND SMALL BUSINESS PERFORMANCE**

Islamic values (akhlaqul karimah) based on Al-Qur’an and Sunnah are Muslims core ethics as to achieve the pleasure of Allah SWT [5]. Submissive Muslim entrepreneurs will be confident and motivated in the workplace besides emphasizing on social contracts and meeting major business obligations [7]. With good orientation in all facets of human life [59], they will possess decent business-related conducts like hard work, commitment, devotion, creativeness, collaboration and competitiveness [84]. In [7, 8] agree on the influence of Islamic values on business and economic activities as those standards are crucial for firm higher performance, all-embracing success and communal welfare [7, 8].

Islamic values should be inculcated to all Muslims since Malaysia is a Muslim country. Researches prove that personal values of entrepreneurs will affect their entrepreneurial capabilities and thus enhance the business performance [65, 76, 67]. Contradictory, in [37] concluded that religious values are irrelevant and insignificant for economic growth. Furthermore, to attain family business success, in [23] gives an insight into Islamic values namely truthfulness, donation, benevolence and positive thinking about conflicts as being prescribed by the Qur’an and Sunnah. A study of Arab-Islamic business organizations by [54] highlight spiritual values, in particular Islamic values can increase employee and customer satisfaction hence improve firm performance. Hence, research on Muslim small business should consider Islamic values as one of the determinants for success since Islamic faith has influenced small entrepreneur’s business practices. Thus, it is assumed that Islamic values influences small firm performance as proposed in the hypothesis below:

- H4: Islamic values are positively related to small business performance.

**THE RELATIONSHIPS BETWEEN INTELLECTUAL CAPITAL, ISLAMIC VALUES AND SMALL BUSINESS PERFORMANCE**

Figure 1 depicts the proposed conceptual framework intellectual capital theories [6, 50], Islamic values [79, 60] and links them to small firm performance [18, 32].

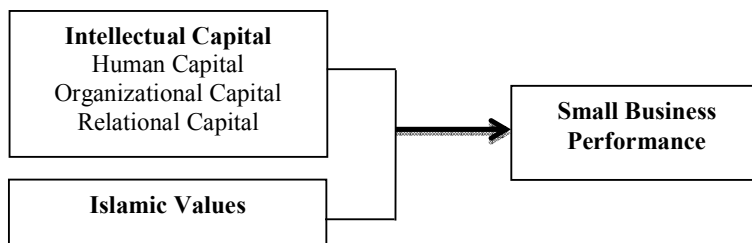


Figure 1: Conceptualization of the relationships between intellectual capital, Islamic values and small business performance

The general structure of suggested effects includes the direct and positive effect that intellectual capital components and Islamic values have on small firm performance. Studies stated that intellectual capital [12, 47] has 3 constructs. It provides an inclusive understanding of the associations among the intellectual capital elements in Figure 1, which explicit magnitudes of the constructs and Islamic values are incorporated in the section on research propositions. This is because different dimensions of intellectual capital and Islamic values may have dissimilar effects on small firm performance.

## IMPLICATIONS FOR THEORY AND RESEARCH

This study has several implications. First, previous studies normally recommend tangible assets as means to enhance firm performance. This study accentuates on intangible assets, such as intellectual capital and Islamic values that are substantively and significantly related to small business performance. Second, while past studies have examined issues concerning intellectual capital [34, 25, 52, 20,61] in big corporations in which their findings are not generalized to small enterprises, this study concentrates on those small businesses. Third, this study generates greater awareness among small entrepreneurs on intellectual capital and Islamic values as they would espouse initiatives and form successful businesses. In fact, identifying the assets that may affect the growth is very important to small entrepreneurs for the purpose of overcoming the weaknesses and attaining competitive edge.

## CONCLUSION

As the deficiency of literature on Malaysian small enterprises in the area of intangible assets and Islamic values, the questions linger whether or not the sector takes appropriate measures consistent with the open economy. This problem should be handled directly as SMEs in developed countries vigorously increase their resources and abilities to grab the competitive edge. Hence, small firms should understand their own competences especially their internal strengths such as their people, practices and external chains in order to be competitive and profitable. Down with labor capital, but knowledge capital and divine ethics will pave the way to be competitive globally. In consequence, this study explores small firm intellectual capital and Islamic values that affect business performance. More importantly, the framework is useful for micro and small business for their long-term competitive gains.

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