

CHAPTER 1

INTRODUCTION

1.1 Background

The economic environment today is much different from the past. Business has globalized, information flow is much faster and easier to obtain, and competition between companies is stiffer than before. The value relevance of traditional annual report is declining (e. g Lev & Zarowin, 1999) and non-financial information likes market size and market penetration were significantly related to the market value (Amir & Lev, 1996). Companies also experienced some transformations, since they believe that their assets were not only the tangible ones, but also the intangibles. Companies turned their focus to the assets that were usually concerned the least, for instance corporate skills, innovations, and of course the abilities or knowledge of their employees or human capital.

Knowledge has become an important word in the business world today. Most people call today's economy as the knowledge-based economy era. The rise of the knowledge-based economy has been attributed to the increasing importance of intellectual capital as an intangible and important resource for companies' sustainable competitive advantage (Roos & Roos, 1997). Most companies are not sufficiently aware of the dimensions of knowledge or of the differences between value creation and value extraction to be able to focus their human capital management energies on the greatest benefit for the firm (Sullivan, 2000). The less awareness of many companies about knowledge is questionable since

knowledge has turned out into one of the economy's prime resource. However, knowledge also influenced the information age companies, since they hire people based on their ability to use knowledge rather than physical abilities.

Many companies' managements believe that they have something that differentiates them from others in the market, which is the intellectual capital that lies in their company. Intellectual capital is one of the three capitals that are owned by a company. The other two are financial and physical capital. The problem is that they realize the hidden value within their company, but they do not know how to get this value from their intangible assets and disclose it for the information users. More than that, they also do not know what they should do about it. The measurement of IC is both difficult and expensive due to information collection, processing and dissemination costs (Revsine *et al*, 1999).

Based on the current situation regarding the intellectual capital discussion, it seems that people already acknowledge the importance of a method to measure and report the value of their intangible assets within their companies. Many practitioners, analysts, and firms worldwide have tried to work on searching for the most suitable methods of identifying, measuring, and reporting intellectual capital within organizations (Berglund, Grönvall & Johnson, 2002). They reached the same conclusions that intellectual capital is of major importance, but few are able to define and quantify it.

Furthermore, the smudge description, lack of information, and many variations of classifying frameworks of Intellectual Capital and intangible assets create such

confusions among investors in the financial market. According to a late 2005 survey by Accenture, forty-seven percent of individual investors say that determining worth of IC and intangible assets is a major challenge. This condition seems not efficient to the capital market since Lev noted (2001, p. 8) a ratio of 6:1 in March 2001 means that of every six dollars of market value, only one dollar appears on the balance sheet, while the remaining five dollars represent intangible assets. The failure to define and quantify intellectual capital could make investors decision become inefficient. Investors could wrongfully value the company with high share of intellectual capital within its organization because it does not appear on the annual report.

Based on the facts and problems above, the writer has an interest to do some study about how the intellectual capital measurement have any relationship with the market capitalization in Indonesian firms since there are just a few researches that have been conducted on intellectual capital measurement. Hence, this thesis objective is to analyze whether there is a correlation between an increase in firm's market capitalization and firm's intellectual capital among Indonesian companies, listed on the Indonesian Stock Exchange. The writer also added another factors that would have any relationship with firm's market capitalization increases, they are firm's age and industries. Furthermore, to perform this study, the writer has decided to use Value added per employee as an approximation of the return of intellectual capital. This assumption is an integral part of this thesis since the measurement and approach for the hypotheses later are using this approximation. Therefore, this thesis is titled **Empirical Research on the**

Relationship Between the Increase of Market Capitalization and Intellectual Capital on Indonesian Listed Companies.

1.2 Scope

This thesis only concerns the relationship between the increase of market capitalization and intellectual by Indonesian companies listed in Indonesia Stock Exchange (ISX). The author investigates the relevant financial figures in the annual report (2003-2005) to calculate the variables in the study. The study sample of this thesis is 40 companies in 4 industries listed on the Indonesian Stock Exchange.

1.3 Aims and Benefits

The objectives of this study include:

1. Analyze whether there is a correlation between the increase of market capitalization and value added per employee, as the proxy of intellectual capital, among Indonesian listed companies in three years of time (2003-2005).
2. To find whether there is another factor that would affect the increase of market capitalization of a company, this research includes company's age and industry as the variables.
3. Identify in what extent the findings of this study. Is similar or identical with related research in other countries.
4. Provide facts that several factors (i.e: intellectual capital) could affect the market capitalization of a company, thus it will give a hint for the management to increase their company value.

1.4 Hypotheses

Hypothesis 1: There is a relationship between Intellectual Capital and the increase of firm's market capitalization.

Hypothesis 2: There is a relationship between firm's age and the increase of firm's market capitalization.

Hypothesis 3: There is a relationship between firm's industry and the increase of firm's market capitalization.

1.5 Research Methodology

The research is an investigate study in the increase of market capitalization and factors that would affect that. The sample is 40 listed companies in the Indonesian Stock Exchange. The detail of research methodology is presented in chapter 3.

1.6 Thesis Structure

The following is the thesis structure of this study:

Chapter 1: Introduction

This chapter describes the background, motivation, scope, and objectives of the study.

Chapter 2: Theoretical Foundation: literature review on intellectual capital

This chapter describes the theory of intellectual capital, its emergence and development.

Chapter 3: Research Methodology

This chapter will explain briefly the research methodology used for this study. Population and study samples, as well as data collection techniques will briefly explained.

Chapter 4: Findings and Discussion

This chapter analyses and discusses the findings of the study.

Chapter 5: Conclusion, Recommendations, and Limitations

This chapter concludes the thesis. Furthermore, recommendations for further study are discussed and limitations of the study will be revealed.