7th International Scientific Conference
"Business and Management 2012"
May 10-11, 2012, Vilnius, LITHUANIA

ISSN 2029-4441 print / ISSN 2029-929X online
ISBN 978-609-457-116-9 CD
doi:10.3846/bm.2012.026
http://www.bm.vgtu.lt

CORPORATE FINANCIAL PERFORMANCE AND VALUE CREATION: THE COHERENCE OF INTANGIBLE ASSETS AND CORPORATE SOCIAL RESPONSIBILITY

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Abstract. The paper analyses the importance of intangible assets and corporate social responsibility to a modern enterprise. Referencing to the literature, the article provides the answer to the questions of the existence of the coherence between intangible assets and corporate social responsibility and the existence of positive relationship between intangible assets, corporate social performance and corporate financial performance. The formality and sophistication of the process used to increase corporate social performance depends on the size and sophistication of the company, as well as the nature and complexity of its activities. The principles focused in the paper have broad applicability to all companies. In particular, good management intangible assets and social responsible activities are crucial elements of high corporate performance indicators at a company of any size or scope of operations.

Keywords: value creation, corporate social responsibility, corporate financial performance, intangible assets, intellectual capital (IC).

Jel classification: G30, G32, M14

1. Introduction

Management of intangible assets, corporate social responsibility is becoming a common concern in business. Not so many studies have been done about position of corporate social responsibility in perspective of intangible assets. Moreover, intangible assets, corporate social performance coherence with corporate financial performance are the topics which are gaining more importance among researchers in Lithuania. The authors have focused on developing a greater understanding of the way in which companies can manage their corporate financial performance using a broad potential of intangible assets and corporate social responsibility. The purpose of this paper is to analyze if intangible assets, CSP have relationship with value creation of the firm, with overall company's performance. In order to get accurate results, importance of appropriate methods was evaluated, so social responsible companies ratings, methods to measure intangible assets were discussed and compared to each other.

According KPMG survey (Valuing Corporate... 2009) made few years ago, the corporate responsibility reporting is now a mainstream expectation of companies. More than 80 percent of the world's 250 largest companies now report on corporate social responsibility. It implements that high Corporate Social Performance is related with key performance indicators (KPI). Such results could encourage companies to invest more in corporate responsibility as well as a determination of methods that can measure relationship of intangible assets and CFP or overall company's performance.

This study aims to examine the relationships between intangible assets and corporate social responsibility and their impact on corporate financial performance at the national level of analysis.

The research methods used in the study were: the conceptual content analysis, which allowed indentifying the most often, used measurements of corporate social performance, intangible assets and corporate financial performance mentioned in the scientific literature; the data analysis, which enabled to indicate the coherence of intangible assets, corporate social responsibility and corporate social performance. The data were collected in November 2011 available from NASDAQ OMX Vilnius.

It was found that there are a relation between corporate social performance and corporate financial performance. Companies with high CSP ratios also are above average according their financial results. More specifically, there is a link between corporate social performance, intangible assets and key performance indicators of the company. The main implication of this study is that the findings demonstrate a coherence of intangible assets and corporate social responsibility and their impact on corporate financial performance at the national level. The study is clearly limited to one country, but offers future researchers a wealth of replication opportunities.

2. Previous research

Research literature attaches considerable attention to the all possible ways in creation of additional value from measurable and touchable assets of companies; as a result, there is a great need to gasp the extra value from every available source, even from intangibles, in order to sustain competitive advantage. Knowledge-based economy and value-based management are gaining more importance and consequently value creation through intangible resources too.

According to Daum J. H. (2005) intangible assets or intellectual capital are immaterial resources (not financial assets/financial capital or physical resources such as fixed/current assets) that, as a factor of production, play a fundamental role in the value creation process of an enterprise and that enable it to compete successfully.

There can be set the clear benefits of orientation of the business towards the knowledge-based economy, value-based management and value creation through intangible assets. Atkočiūnienė (2008) explains that knowledge management helps the organization to manage the important information which is employed in daily business operations such as strategic planning and decision-making. Atkočiūnienė (2008) also points that effective management of intellectual capital leads the organization to competitive advantage.

New developments reflect themselves in the contribution of value-based management (VBM) to overall success of the organization is also considerable. Evidence reveals that, under the culture of VBM, employees can make better decisions with authorization and work more efficiently in their team due to the complete devotion, risk taking, and sharing of ownership of work by each employee. VBM can, therefore, combine employees' interests with value and profit/loss in business (Marr, Schiuma, Neely 2004).

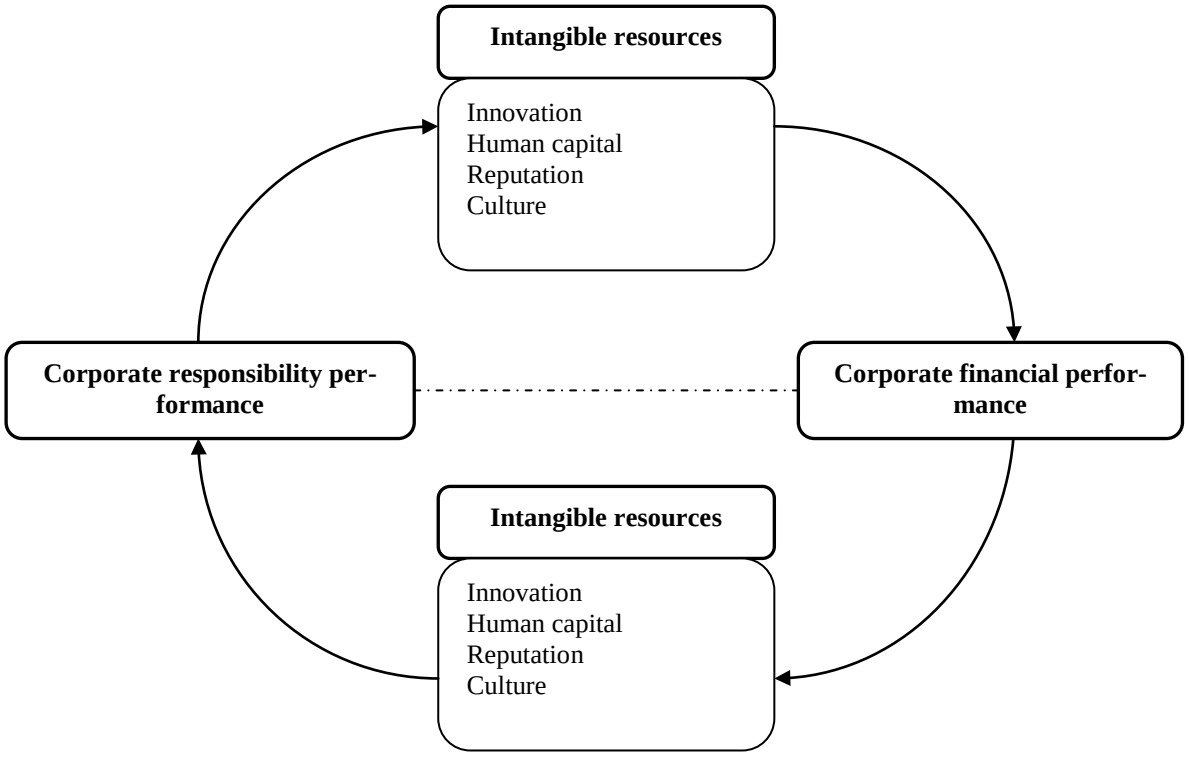

Fig.1. Relationship between corporate social responsibility and intangible assets (adopted from Surroca *et al.* 2010)

Marr, Schiuma, and Neely (2004) describe the importance of intangible assets referencing to the Hiroyuki Itami, here intangibles are considered to be long-term success factors, according them only invisible assets can be used simultaneously in several areas. Researchers have also denoted how value creation can be obtained from intangible assets. According to Kaplan and Norton (2004), there are four principles of creation of extra value from intangibles – value creation from these assets is indirect, value of intangibles depends on its alignment with strategy of organization, value of intangible assets is potential and can be turned into tangible value and, lastly, the value of intangibles can be gasped when they are adjusted with tangible assets.

Intangible assets and intellectual capital can be dispersed into constituent parts which can add value to a company. Mačerinskienė, Survilaitė (2011) carried out a survey of small and medium-sized companies of Lithuania on intellectual capital, its composition and the effects of intellectual capital on value added of the company. Consequently, intellectual capital was split into elements such as product quality, motivation, customer relations, experience, prestige, etc. The survey showed that respondents find product quality as most important element; however, it was observed that social activity is being important element of intellectual capital.

Corporate social responsibility (CSR) is related to ethical and moral issues concerning corporate decision-making and behavior. CSR is related to complex issues such as environmental protection, human resources management, health and safety at work, relations with local communities, and relations with suppliers and consumers. More and more businesses call themselves social responsible, more and more companies submit their CSR reports next to annual financial reports. Corporate social responsibility and intangible assets tight relationship is illustrated in Fig. 1.

Many research works focus on the reputation as one of the most important intangible assets. Iwu-Egwuonwu (2011) describes the work of Wang and Smith (2008). These last two authors succeed in showing that the behavior of reputable organizations creates intangible assets that are as valuable as would distinguish them from their peers in the industry. Again, there are competing views about possible coherence between the reputation and corporate social responsibility coherence. McKinsey proved global survey "Valuing corporate social responsibility" (2009), where majority of respondents (CFOs, investment professionals, corporate social responsibility professionals) states that building reputation is the best way to increase CFP.

As far as the coherence of corporate social performance and intangible assets was indicated, then in order to find the relationship of intangible assets and CFP, KPI or the relationship of intangible assets and value creation of the firm, the existence of the link between corporate social performance and aforementioned fields was investigated and CSP was treated as a kind of intangible assets.

There have already been a lot of studies and theories stating that there is a positive relationship between CSP and CFP, as well as there are a lot of studies which do not find any relationship between CSP and CFP or even find negative relationship. As Branco M. C. and Rodrigues L. L. (2006) stressed that one of the most famous examples was M. Friedman, who emphasized that the organization should not harm society, but also denied that it should assume any wider social responsibility for its maintenance and improvement. Analysis related with Friedman's theory usually does not find positive relationship between CSP and CFP.

However, other scholars, have espoused that positive relationship between CSP and CFP exist and highlighted instrumental stakeholder theory (*e.g.* Clarkson 1995; Cornell and Shapiro 1987; Donaldson and Preston 1995; Freeman 1984; Mitchell *et al.* 1997). The classification of these studies as exemplifying "instrumental stakeholder theory" was made *ex post*.

According to Margolis and Walsh (2001), 80 of the 95 cases they reviewed, which were published between 1972 and 2000, states that CSP predicts or helps to determine CFP. Of the 80 papers identified by Margolis and Walsh (2001) as modeling CSP as a determinant of CFP, over half report a positive relationship; included among these are Waddock and Graves (1997), Dowell *et al.* (2000), and Graves and Waddock (2000). Similarly, Pava and Krausz (1996) find that of the 21 empirical papers they reviewed, which were published between 1972 and 1992, 12 of them, or 57 %, determine that a positive relationship exists. In fact, Pava and Krausz (1996: 324) argue that the overwhelming preponderance of the evidence indicates that CSR firms perform at least as well as other firms (Callan, Thomas 2009).

3. Research methodology/measuring intangible assets and CSP

In order to evaluate the intangible assets Value Added Intellectual Coefficient (VAIC^{TM}) was chosen. VAIC^{TM} was proposed by Ante Pulic and developed to measure the value creation efficiency of a particular firm (Muhammad, Ismail, 2009; Kujansivu, Lönnqvist, 2005). This approach indicates that Intellectual Capital (IC) is a core element in corporate value creation (Makki, Lodhi 2009). According to authors (Baros *et al.*, 2010; Kujansivu, Lönnqvist, 2005; Makki, Lodhi, 2009; Muhammad, Ismail, 2009; Murale, Jayaraj, Ashrafali, 2010; Rehman, Iiyas, Rehman 2011), the procedure of calculation of VAIC^{TM} fall into several steps:

Step 1. Calculation of value added:

$$VA = P + C + D + A, \quad (1)$$

where:

P – operating profits;

C – employee costs (salaries and social expenses of staff);

D – depreciation,
A – amortization;

Step 2. Structural capital:

$$SC = VA - HC, \quad (2)$$

where:

HC – the sum of total salaries of the company;

Step 3. Capital employed efficiency:

$$CEE = VA/ CE, \quad (3)$$

where:

CE – capital employed;

Step 4. Human capital efficiency:

$$HCE = VA/ HC, \quad (4)$$

Step 5. Structural capital efficiency:

$$SCE = SC/VA, \quad (5)$$

Step 6. Intellectual capital efficiency:

$$ICE = HCE + SCE, \quad (6)$$

Step 7.

$$VAIC^{TM} = ICE + CEE. \quad (7)$$

As a result, the additional value can be created by the intellectual capital and capital employed of the company. Further research given by Kujansivu P. and Lönnqvist A. (2005) demonstrated that the higher the VAIC^{TM} and ICE were, the better management had utilized the existing potential in the resources employed in creating value and evaluates how effectively organization's IC adds value to the organization.

From the pragmatic perspective, corporate social responsibility is defined as the intangible asset. Based on the previous discussion, the following calculations were done in order to see if companies with high CSP have higher VAIC than others and if corporate social performance affects the value of intangible assets as well.

We utilize the well-know standard approach KLD (Kinder, Lynberg, Domi Research and Analytics) as one of the most common measure for corporate social performances. Alternatively the DJSI provides a composite group of firms seen as sustainability leaders in their respective industries with regard to innovation and future orientated management (DJSI 2002). The DJSI derives its investment universe from the Dow Jones Global Index (DJGI), the latter being a global equity index that covers more than 4,500 firms and represents 95 % (80 % prior to June 2000) of the world's free float equity market (DJGI 2002). The DJSI has identified five main areas of corporate sustainability when assessing the respective CSP capabilities of firms (Lee *et al.* 2009).

On the one hand, there are some critics for those two and other indexes, for example, a group of researchers from Harvard Keneddy School raises a question about transparency of those indexes. However, according to the research made by McKinsey Company, investors pay attention to CSP of companies, and those indexes are main measures for CSP. These measures/indexes help to differentiate companies according their CSP and then compare to their CFP or KPI. This leads to answers if it pays off to be social responsible.

There are no studies made which would lead to indexes that measure CSP of Lithuanian companies. Only "*The Global compact*" provides the list of the companies, which are considered as the organizations with high CSP. Further, companies with high CSP and listed on NASDAQ OMX Vilnius (in order to have all necessary financial data) were analyzed in the study and their measures of CFP, KPI were compared with the average measures of other companies that are listed on NASDAQ OMX Vilnius. The data used for the analysis originated from NASDAQ OMX Vilnius available in November 2011. The data of following companies were used in study: TEO, Apranga, Klaipėdos kartonas (Grigiskes), Utenos trikotažas, LESTO (in this study all financial data is taken from VST), Vilniaus Baldai, Kauno energija. LESTO and TEO were honoured as National Responsible Business Awards Winners in 2010.

4. Measure of corporate financial performance, key performance indicators: ROA, ROE, EVA, MVA, Tobin's q

The theoretical basis for the measurement of corporate financial performance is driven from the findings of Orlitzky *et al.* 2003. The most common measures appear to be ROA and ROE.

In analyzing the influence of intangibles on corporate financial performance, traditional financial management tools for financial performance measurement such as return on assets (ROA), return on equity (ROE), *etc.*, seem to lack tools needed to appraise intangible assets. Researchers argue (Bontis *et al.* 1999; Rakshit 2006) that return on assets (ROA) and return on equity (ROE) tend to underestimate the cost of capital involved in generation of profit. Petravičius (2008) observes that dearth of methodologies for evaluation of intangible assets,

and the inadequacies in accounting standards concerning the appraisal of intangible assets leads to the application of new financial performance measurement tools.

Alternative measurement – Economic Value Added, EVA™, was introduced by Stern Stewart & Co., as a tool to assist corporations to pursue their prime financial directive by aiding in maximizing the wealth of their shareholder (Bontis *et al.* 1999). In the broadest terms, EVA™ is a comprehensive financial management measurement system that can be used to tie together capital budgeting, financial planning, goal setting, performance measurement, shareholder communication, and incentive compensation. Referencing to Rakshit (2006), EVA™ can be calculated:

$$EVA = NOPAT - WACC \times CAPITAL\ EMPLOYED, \quad (8)$$

where:

NOPAT – refers to net operating profit before tax

WACC – corresponds to weighted average cost of capital and can be calculated by the following formula (Farooq et al. 2010):

$$WACC = r_e \frac{S}{V} + r_d (1-T) \frac{D}{V}, \quad (9)$$

According to Seggie *et al.* (2007), EVA™ > 0, then it is worth investing and vice versa, if EVA™ < 0, such investment possibility should not be accepted. When EVA™ is equal to 0, then the return on investment counterbalances the risk taken by an investor (Petravičius, 2008). Wibowo and Berasategui (2008) point out that positive EVA™ corresponds to value creation while negative is not.

MVA™ is a significant summary assessment of corporate performance – showing how successful a company has been in allocating, managing and redeploying scarce resources to maximize the NPV of the enterprise and hence the wealth of shareholders (Bontis *et al.* 1999). If MVA™ > 0, then value of an investment exceeds the amount of invested capital and, if MVA™ < 0, then the quantity of invested capital is more considerable than the value which can be generated from the investment (Wibowo, Berasategui 2008). According to Petravičius (2008), MVA™ can be calculated as a difference between capitalization and invested capital.

Other financial measure that is taken in to account – Tobin's *q* ratio. According to Callan and Thomas (2009) Tobin's *q* as Company's Financial Performance indicator were used by King and Lenox (2001), Konar and Cohen (2001). Tobin's q can also be found in work of Chung and Pruitt (1994), Megna and Klock (1993), Wolfe and Sauaia (2003).

Surroca *et al.* (2010) stated Tobin's *q* ratio is considered as a proxy to P/B ratio according Waddock and Graves (1997), the high values of the P/B ratio, recognize firms as having a strong competitive advantage as well as a strong brand image or expertise (Lindberg, Ross 1981). In addition, companies with low P/B ratios are more likely to be seen as takeover targets (Hasbrouck 1985), and suffer from poor management (Lang, Stulz 1994).

Tobin's *q* ratio was used as a measure of CFP, mainly because of its ability to capture the value of long-term investments like intangible investments, as explained by Dowell *et al.* (2000).

$$Tobin's\ q = (Capitalization + preferred\ stock + DEBT)/ TA, \quad (10)$$

where:

DEBT – is calculated as difference between short-term liabilities and short-term assets plus book value of long-term debt.

Firms with high *q*, or $q > 1$, have been found (Wolfe, Sauaia 2003) to be better investment opportunities, have higher growth potential and indicate management has performed well with the assets under its command.

5. Results and discussion

There are 7 companies (TEO, Apranga, Klaipedos kartonas (Grigiskes), Utenos trikotazas, LESTO (in this study all financial data is taken from VST annual reports), Vilniaus Baldai, Kauno energija.) taken with high CSP, other 7 companies are also taken from Vilnius Stock Exchange main share list on NASDAQ OMX Baltic. Companies from financial sector are not involved in this investigation. Data was taken from year 2010 annual reports. All necessary calculations are done in order to get VAIC™: calculation of value added, structural capital efficiency, human capital efficiency, structural capital efficiency, intellectual capital efficiency. The results of the study presented in the Table 1.

The results of the study represent an attempt to move from a conceptual view of the coherence of intangible assets and corporate social responsibility and their impact on corporate financial performance to a more concrete definition of the construct.

The findings are clearly encouraging: companies' with high CSP VAIC™ as every mentioned determinant (except capital employed efficiency) average is higher than average of all 14 companies. Tobin's *q*, market value added, economic value added average ratios of companies with high CSP were higher than the average of all 14 companies.

Table 1. The coherence of intangible assets and corporate social responsibility and their impact on corporate financial performance

Company	*VA, (mln. LTL)*	*CEE*	*HCE*	*SCE*	*ICE*	*VAIC*	*TOBIN'S Q*	*ROA, %*	*ROE, %*	*EVA, (mln. LTL)*	*MVA, (mln. LTL)*
City Service	27.363	0.010	1.514	0.339	1.854	1.864	0.091	6.86	10.49	1.685	-112.928
Sanitas	8.440	0.026	1.742	0.426	2.168	2.195	1.724	-0.49	-0.61	-0.108	290.093
Panevėžio statybos trestas	44.229	0.317	1.540	0.350	1.891	2.208	0.152	8.99	15.03	14.922	-8.779
Rokiškio sūris	232.938	1.253	1.148	0.129	1.278	2.531	0.546	8.07	13.61	18.943	55.061
Utenos trikotažas	23.289	0.561	1.662	0.398	2.060	2.622	0.703	-1.31	-4.17	-1.586	7.453
Pieno žvaigždės	46.840	0.239	1.940	0.484	2.424	2.664	0.995	5.70	12.63	6.566	129.957
Vilniaus baldai	27.270	0.354	1.893	0.471	2.365	2.719	0.782	25.63	38.30	18.637	54.673
Apranga	27.890	0.311	1.932	0.482	2.415	2.727	3.189	5.88	7.83	0.969	306.223
Vilkyškių pieninė	26.086	0.313	1.944	0.485	2.429	2.742	0.911	9.59	23.77	9.147	21.117
TEO	359.055	0.352	2.213	0.548	2.762	3.114	1.457	14.15	16.44	59.125	920.480
Kauno energija	35.125	0.110	2.621	0.618	3.239	3.350	0.254	0.91	1.43	-3.795	-219.085
Lietuvos dujos	198.015	0.081	2.889	0.653	3.543	3.624	0.544	5.90	7.68	30.260	-896.301
Lesto	303.790	0.112	4.533	0.779	5.312	5.425	0.664	2.31	3.92	24.117	-636.035
Grigiškės	19.479	0.178	4.998	0.799	5.798	5.977	1.345	1.02	1.90	-2.833	80.451
Average	98.557	0.301	2.326	0.497	2.824	3.126	0.954	6.66	10.57	11.809	-0.537
Average of the companies with high CSP	113.699	0.283	2.836	0.585	3.422	3.705	1.199	6.94	9.34	13.518	73.464
Average/ average of the companies with high CSP	11.536	0.938	1.219	1.176	1.211	1.185	1.256	1.04	0.88	1.144	-136.590

There is no tendency that companies with high CSP would have higher average of return on assets, return on equity than all 14 companies. However, it should be noticed that when selecting the top 5 companies in every measure, 3 out of 3 companies which appear to be leading in this comparison are companies with high CSP.

Comparing results with other research's *e. g.* Volkov and Garanina (2008), Garanina (2009) have tested the Russian market and discovered that the tangible assets play a more important role than intangibles in value creation. The same situation was discovered in UK market by Garanina and Pavlova (2011).

Muhammad and Ismail (2009) investigated the Malaysian financial sector and discovered that banking sector depend mostly on intellectual capital than other participants of the sector. They also found the existence of positive relationship between intellectual capital and profitability of the company and return on assets (ROA). Makki and Lodhi (2009) have developed the research on Pakistani corporate sector which revealed that the efficiency of intellectual capital influences the return on investment of particular company. Murale, Jayaraj, Ashrafali (2010) analyzed the IT service sector of India and discovered the relationship between intellectual capital and market-to-book value and the relationship between VAIC™ and financial performance of a company.

In Lithuania, the subject-matter of intangible assets and value creation also gaining importance, many authors ventilate this research area (Karalevičienė, Matuzevičiūtė, 2008; Mačerinskienė, Survilaitė, 2011; Mikulėnienė, Jucevičius, 2000; Palumickaitė, Matuzevičiūtė, 2007; Užienė, 2010; Znakovaitė, Pabedinskaitė, 2010).

Mačerinskienė, Survilaitė (2011) carried out a survey of small and medium-sized companies of Lithuania on intellectual capital, its composition and the effects of intellectual capital on value added of the company. It showed that human capital influences the company's value added mostly. Karalevičienė, Matuzevičiūtė (2008) conducted a survey on determination of the level of intellectual capital in industrial sector of Lithuania. The study showed that the highest level of intellectual capital contributed to construction and IT sectors while the lowest – to textiles sector companies. Znakovaitė, Pabedinskaitė (2010) evaluated the management of intellectual capital in transport sector of Lithuania and Latvia and found that intellectual capital is a key for successful amplification of revenue.

Future studies could undoubtedly improve the quality and reliability of findings by replicating the study in multiple organizations.

6. Conclusions

The study obtained clearer picture on how intangible assets and CSR are related. When measuring value of intangible assets, CSP can be measured as it is an appropriate expression of intangible assets: companies with high CSP usually would have higher VAIC, in Lithuanian market as well.

Companies with higher key performance indicators appeared to be the ones with high CSP, higher evaluation of intangible assets, so the empirical part of the article suggests that coherence exists. The biggest average difference between companies with high CSP and all 14 companies average is when measuring Tobin's q ratio it rises a question which is the cause of which.

Looking at the existing relationship of intangibles and CSR and its role in key performance indicators (or vice versa), there is still a room for further studies.

In order to have more accurate results the CSP should be measured more carefully in Lithuanian market, index could be created so the results would be more reliable.

When separately measuring the average of return on assets, return on equity, it opens interesting discussion about possible measuring company's performance in a short run, in this case, the positive relationship between intangible assets, CSP and company's performance can be not found.

However, it should be noticed that when selecting the top 5 companies in every measure, 3 out of 5 companies which appear to be leading in this comparison are companies with high CSP.

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