How Do Intellectual Capital and Islamic Work Ethics Affect SME Business Performance?

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ABSTRACT

This paper explores the effect of intellectual capital (IC) and Islamic Work Ethics (IWE) on Small and Medium Enterprise (SME) business performance. Based on a qualitative study, the results provide support to SME entrepreneurs to understand the effects of IC and IWE on business performance and facilitate them in making the right decision. The qualitative results were obtained from documents analysis and interview sessions. For the interview session, three entrepreneurs (regarded as the key informants) provided a deeper understanding on how IC and IWE had managed to influence SME Business Performance. SME entrepreneurs must realise on the need to maintain a competitive advantage and enhance the opportunity to create profitability through extracting value from IC and IWE. The originality of the paper regards the way it addresses simultaneously IC and IWE, such related concepts. Moreover, findings of this study suggest that SME entrepreneurs should extend practices of Islamic work ethics to employees, customers, vendors, partners and the communities by building a positive environment founded on trust and commitment.

Keywords: SME, intellectual capital, Islamic work ethics

INTRODUCTION

SMEs are normally being viewed as the engine of economic growth and are believed to play a vital role in employment creation. Wind & Main (1998) have argued that relative to larger firms, SMEs are well placed to react to the challenges of turbulent globalisation markets since they are flexible, innovative and entrepreneurial. There has been increasing interest in Malaysian government in the role of SMEs for competitiveness initiatives. SME matters in Malaysia because 98.5% of business establishments in Malaysia are SMEs. There are 907,065 establishments of SMEs which contribute 36.6% of Malaysia's GDP in 2016 (SME Corporation Malaysia, 2018). Strategic flexibility implementation for SMEs can be improved with the creation of IC as it is considered as a strategic asset. Marzo & Scarpino (2016) explored the characteristics of intellectual capital in managerial perspectives in relation to the firm size. They argued that methods formerly meant for bigger companies cannot really consider SMEs’ features. To rebut this statement, Abdullah & Othman (2019) had provided evidence that higher level of firm performance among Malaysian SMEs is positively influenced by higher level of knowledge and intellectual capital.
Many researches categorise intellectual capital into three main elements: human capital, organizational capital and customer (relational) capital (Marzo & Scarpino, 2016; Bani et al, 2014; Maditinos et al, 2011; Yang & Lin, 2009; Reed, Lubatkin & Srinivasan, 2006). Basically, the components of IC could deliver a more transparent comprehension of the concept and its impact on business performance (Choo Huang, Luther & Tayles, 2007; Marcin, 2013).

Better performance of the whole organization and individual satisfaction can be achieved via innovative and productive works promoted by IWE (Ali, 1988) as it affects organizational commitment (Salahudin et al., 2016) for. This is due to the fact that individuals with high IWE demonstrate more sense of belongings compared to those with low Islamic work ethics (Murtaza et al., 2016). Alhyasat (2012) points out that IWE have great influence on behaviours of employees; particularly they become highly committed; and likely to give more effort and work beyond their job requirements. Indeed, such employees are better to involve voluntary behaviours that recover the work situation of their organizational peers, even in the presence of family-to-work conflict (De Clercq, Rahman & Haq, 2019). Abbasi, Mir & Hussain, (2012) argued that adhering to Islamic work ethics in business organization learning, innovation and ultimately business performance.

The aim of this study is to assess how IC and IWE affect SME business performance in Malaysia. Using qualitative study based on phenomenology approach, the study opens up a phenomenon and makes sense of its invariant structure across all narrative accounts. In this approach, the focus is on the lived experiences of those deeply familiar with the phenomenon and how they experience the phenomenon as they are going through it’ (Mihas, 2019). In view of that, this research study is designed specifically to understand how SMEs in Malaysia leverage their IC and IWE in achieving efficient business effective value added.

The remainder of the paper is organized as follows. Section 2 describes the methodology of research; Section 3 illustrates the results; Section 4 contains the discussion. The final section concludes the paper.

**METHODOLOGY**

Qualitative information was collected from the semi-structure interviews and document analysis. Researcher chose six entrepreneurs from different types of business (i.e. commerce and services, construction, consultancy, manufacturing, property, and agriculture) who would respond differently to the dependent variable. This approach is in line with Creswell (1998) who recommends 5 – 25 and Morse (1994) who suggests at least six. The potential participants were contacted prior to the interview session. Out of six entrepreneurs approached for the interview, only three agreed to participate. The interviewees’ preferred day, time and venue were asked. Participants were also asked to bring their company’s annual reports, financial statements or any other related materials during the interview session. Table 1 describes the entrepreneurs who are willing to be interviewed and their company’s background.

The one-to-one interview conducted by researcher lasted for about one to two hours for each participant. Semi-structured questions related to the themes of human capital, organizational capital, relational capital and Islamic work ethics were used as guides in the interview sessions. However, interviewees were allowed to talk on other related issues as they pleased. Researchers followed Smith and Osborn’s (2003) advice in which a consistent means were provided to analyse the interview data, and informed interviewees beforehand on the themes used in this study. It was a paper and pen method and so researchers did not entail computing technology in the analysis of transcripts. Nevertheless, all the interviews were audio-taped and transcribed in verbatim reports.
Table 1: Entrepreneur’s and SME’s Background

| No. | Entrepreneur’s Background | SME’s Background | Label |
|-----|---------------------------|------------------|-------|
| 1.  | Education level  
  ▪ Degree  
  ▪ Former Petronas accountant | Business type – construction  
  ▪ Involved in the current business – 10 years  
  ▪ No. of Workers – 60 people  
  ▪ Average monthly income – RM35,000 | ENT 1 |
| 2.  | Education level  
  ▪ Diploma  
  ▪ Attended various entrepreneurial courses handled by MARA | Business type – commerce (trading and retailing)  
  ▪ Involved in the current business – 13 years  
  ▪ No. of Workers – 21 people  
  ▪ Average monthly sales – RM40,000 | ENT 2 |
| 3.  | Education level  
  ▪ Degree  
  ▪ Received Graduate Entrepreneur Fund Scheme from SME Enterprise Corporation Malaysia (SME Corp) | Business type – commerce and services (specialized in sign making and printing)  
  ▪ Involved in the current business – 11 years  
  ▪ No. of Workers – 17 people  
  ▪ Average monthly income – RM40,000 | ENT 3 |

RESULTS

Prior to asking any questions, researchers briefly provided an overview of the study, including a definition of IC and IWE. Also, participants were asked to hand in any documents or materials regarding their company. The same ten questions concerning IC and IWE in their workplace were asked by researchers to each participant.

Documents

Only one company (ENT 3) provided documents during the interview session. The documents are balance sheet and income statement (see Table 2 and Table 3).

Table 2: Balance Sheet as at 31 December 2015 ENT 3 Sdn. Bhd

|                      | 2015 (RM) | 2014 (RM) |
|----------------------|-----------|-----------|
| PLANT AND EQUIPMENT  | 311,448   | 160,681   |
| CURRENT ASSETS       |           |           |
| Inventories          | 51,902    | 61,390    |
| Receivable           | 67,087    | 57,180    |
| Cash and bank balance| 4,008     | 11,967    |
|                      | 122,997   | 130,537   |
| Less: CURRENT LIABILITIES |         |           |
| Payables             | 279,456   | 293,276   |
| Borrowing            | 36,007    | -         |
| Taxation             | 5,810     | 2,310     |
|                      | 321,273   | 295,586   |
| NET CURRENT LIABILITIES | (198,276) | (165,049) |
|                      | 113,172   | (4,368)   |
To analyse the contents of these documents in terms of the financial condition and intellectual capital, Ramboll’s holistic account model was utilised. Specifically, the model describes how financial results are a function of satisfaction, work situation, resources (intellectual capital) and the company’s goals, values and management. The information in Ramboll’s holistic accounts for financial results is as follows:

### Table 4: Key Area and Indicators Used in Ramboll’s Model on Financial Results

| Key area          | Focal points                  | Sample indicators           |
|-------------------|-------------------------------|------------------------------|
| Financial results | Earning capacity              | Net profit ratio             |
|                   | Generation of cash flows      | Return on assets             |
|                   | Financial key figures         | Return on equity             |

Source: Adapted from Nazari (2010)

Consequently, this study assessed ENT 3’s financial situation in order to discover the existence of intellectual capital in the company. Table 5 and Table 6 exhibit the assessments of ENT 3’s financial condition.
### Table 5: Calculation of Financial Ratios

| RATIO (STANDARD) | FORMULA | 2015 | 2014 |
|------------------|---------|------|------|
| Current Ratio (2 : 1) | Current Assets = 122,997/321,273, 321,273 = 0.38X | 130,537/295,586, 295,586 = 0.44X |
| Liquidity Ratio (1 : 1) | Liquid Current Asset = 71,095/321,273, 321,273 = 0.22X | 69,147/295,586, 295,586 = 0.23X |
| A/c Receivables Turnover (30days) | A/c Receivables X 360 Sales = 67,087/(519,101 X 0.8) X 360 = 58.16 days | 57,180/(510,652 X 0.8) X 360 = 50.39 days |
| A/c Payables Turnover (30 days) | A/c Payables X 360 Cost of Good Sold = 279,456/210,962 X 360 = 476.88 days | 293,276/204,179 X 360 = 517.09 days |
| Stock Turnover (30 days) | Inventory X 360 Cost of Good Sold = 56,646/210,962 X 360 = 96.66 days | 51,560/204,179 X 360 = 90.91 days |
| Debt/ Equity (<. 5) | Long Term Debt Shareholders’ Equity = 128,990/-ve15,818 = -ve815% | N/A |
| Assets/ Sales (0.6 – 1.0) | Total Tangible Assets Sales = 618,522/519,101 = 119.15% | 406,392/510,652 = 79.58% |
| Net Profit ratio (7-10 % ave.) | Net Income Net Sales = -ve51,448/519,101 = -ve9.92% | 6,877/510,652 = 1.35% |
| Gross Profit ratio (40 %) | Gross Income Net Sales = 308,139/519,101 = 59.36% | 306,473/510,652 = 60.02% |
| Return on equity (15% Minimum) | Net Income Shareholders’ Equity = -ve51,448/-ve15,818 = 325.25% N/A | 6,877/-ve4,368 = -ve157.44% N/A |
| Return on Assets (15% Minimum) | Net Income Total Assets = -ve51,448/122,997 = -ve41.8% N/A | 6,877/130,537 = 5.3% |
| Interest Coverage ratio (2.5 – 3 X) | EBIT Finance Cost = -ve43,038/4,910 = -ve8.77X | 8,421/1,544 = 5.45X |

### Table 6: Summary of Financial Ratio Results

| RATIO | 2015 | 2014 | STANDARD RATIO |
|-------|------|------|----------------|
| Current ratio | 0.38X | 0.44X | 2X |
| Acid Test ratio | 0.22X | 0.23X | 1X |
| Gross Profit ratio | 59.36% | 60.02% | 40% |
| Net Profit ratio | -ve 9.92% | 1.35% | 10% |
| Stock Turnover | 3.72X or 96.66 days | 3.96X or 90.91 days | 12X or 30 days |
| A/c Receivable Turnover | 6.19X or 58.16 days | 7.14X or 50.39 days | 12X or 30 days |
| A/c Payable Turnover | 0.755X or 476.88 days | 0.696X or 517.09 days | 6X or 60 days |
| Return on Equity @ ROE | N/A due to Loses | N/A due to Loses | 15% |
### Table 6 (continued)

| Focal points                  | Sample indicators  | 2015      | 2014      | Standard Ratio |
|-------------------------------|--------------------|-----------|-----------|----------------|
| Earning capacity              | Net profit ratio   | -ve 9.92% | 1.35%     | 10%            |
| Generation of cash flows      | Return on assets   | -ve41.8% N/A | 5.3% | 15%            |
| Financial key figures         | Return on equity @ ROE | N/A due to loss | N/A due to loss | 15% |

*Credit Sales (revenue) was 80% of Total Revenue.
N/A – Not Applicable

Based on Ramboll’s holistic accounts method, the results for indicators of financial condition are as follows:

### Table 7: The Results for Indicators of Financial Condition

| Focal points                  | Sample indicators  | 2015      | 2014      | Standard Ratio |
|-------------------------------|--------------------|-----------|-----------|----------------|
| Earning capacity              | Net profit ratio   | -ve 9.92% | 1.35%     | 10%            |
| Generation of cash flows      | Return on assets   | -ve41.8% N/A | 5.3% | 15%            |
| Financial key figures         | Return on equity @ ROE | N/A due to loss | N/A due to loss | 15% |

ENT 3’s financial health is generally weak, thus indicates minimal level of intellectual capital. A high gross profit ratio (59.36%) did not enable ENT 3 to earn profit in 2015. Profits were diminished by high cost on staff, administration, operating and finance which lead to –ve 9.925% net profit ratio. ENT 3 claimed that they invested on buying a new printing machine for RM212,130 in 2015 and added the number of employees at the end of year 2014. These probably the reasons for their reduced profits. The return on assets (ROA) ratio showed that the management had faced difficulty in employing total assets to make a profit. Comparing 2015 with 2014, staff cost increased by 9.08% (RM16,782), administration cost increased by 21.48% (RM16,782), operating cost increased by 50.99% (RM20,725) and finance cost increased by 31.8% (RM 3,366). Revenue increased by RM8,449 but costs increased by RM56,491. The increase in cost was due to the increased in the number of skilled staff and the purchase of a new machine. If the management wanted a five-year pay back period on the new assets, revenue should increase by RM42,426 annually.

Furthermore, ENT 3 had poor current ratio and acid test ratio, both in 2014 and 2015. The ratios were less than 1. It means that the company had problems in paying its bill, thus lead to liquidity and cash flow problems. The inventory turnover (96.66 days in 2015) showed that the company was facing difficulty in replacing their stock. It might be due to slow completion of its projects. Work in progress cannot be billed, thus reducing sales potential. As for account receivable turnover, ENT 3 had problems in collecting cash from debtors. ENT 3 should review its credit policy and improve its debt collection. Since the company had weak financial results in 2014 and 2015, minimal intellectual capital was created in the organization. To augment the level of intellectual capital, sales and revenue should be increased by 15% – 20% annually. If the break even analysis is used (Total Fixed cost / Gross profit ratio) as a measurement, ENT 3’s revenue should be RM599,888.81 to break even in 2015.
Interview

Semi-structured interviews were conducted based on five themes (human capital, organizational capital, and relational capital). All three company’s owners/managers, who took part in this stage as interviewees, had been at director level for an average of ten years. Obviously, they have strategic overviews of both company’s past and future.

Theme: Human capital
In general, the results revealed that human capital is often regarded as one of the important elements for a company to develop and grow. The participants highlighted that human capital was the most critical in SMEs because they perceived that their business required substantial skills, knowledge and experience. The following examples demonstrate the point.

ENT 1: Our workers are important in delivering our business strategy. Therefore, we get can the best knowledge and skills from the people we have and if they don’t have certain skills, we can hire somebody else when we need. My uncle was a contractor. After graduated from university, I joined his company after about 4 years, I set up my own.

ENT 2: My work experience helps me a lot in running this business. When I was 20 years old I worked in a Chinese trading company. I learned how the Chinese do their business. You really need to know how to tackle the market and the whole operation of the business...especially when you have a new product.

ENT 3: Yes. I worked in a printing company before. From there, I was interested in the business and tried to start my own company, doing only business cards and wedding invitation cards. It was very tough at that time to get customer.

Besides skills and knowledge, education also seems to be a significant component of human capital. The only entrepreneur who had experienced significant university level entrepreneurship education did find it some value in terms of knowledge and skills development in writing a business plan. But he recollected in the interview that this had not been his initial inspiration to start a business.

ENT 2: I think the entrepreneurship subject during my diploma education did help. Writing a business plan is always good when you want to go the banks. Emm...at that time I didn’t think it would [help]...But I think business has moved on a lot now and is a lot more complicated.

In contrast, the other two participants had the opinions that university education is not a contributing factor to entrepreneurship. They believed that they had not developed skills and knowledge in their studies that were directly relevant to entrepreneurship. Sometimes, they saw university as not being helpful in establishing their businesses.

ENT 1: I know surely with my university degree, I don’t see any way that it has helped me. I think whether or not I’d done that accounting degree, I’d been doing exactly the same thing.

ENT 3: I studied Political Science at [X university]. Has it helped me? No, not in the smallest amount. Did I enjoy it? It was quite fun to be a university student at the time. I enjoyed the experience of studying at tertiary level...I’ve thought about this quite a lot and I think I’m not going to let my children to acquire a very specific skills or knowledge...for examples if they want to be a doctor or engineer.
Theme: Organizational capital

Analysis of data from interviewees exposed the major theme of organizational capital, being and important element in their organizations. The entrepreneurs are aware of the significance in implementing procedures and systems within their organizations. However, with regard to administrative and financial aspects, routines, guidelines, manuals and databases are obviously deficient.

ENT 3: From time to time, we have product developments. That is why we are buying a new printing machine which is very sophisticated and can produce more. We believe in new work process development. Though it costs a lot...I believe that the work will be much easier and in the future...my company will gain profits. ..[grinned]..Well, actually I have asked my accountant to do the projected calculation already.

ENT 2: I do not have any operating model for my company but I have dedicated workers who can deliver high quality services to the customers. But I have a one stop centre business...I have a futsal court, restaurant, convenience shop and laundry/dobi service. I will provide car rental service next month.

Only one interviewed SME confirmed having routines. They have established procedures and processes so that their employees can follow easily.

ENT 1: Yes, our company does have routines in which everything is scheduled. ‘Mandur’ (the supervisor) will explain on job descriptions and designated responsibilities to the workers.

Theme: Relational capital

The entrepreneurs’ perceptions of the relational capital dimension showed a concern with management of the company’s stakeholder relations. The companies’ primary focus was on customer relations, but it also involves in actions focusing on suppliers and the community.

ENT 2: We try to gain customer satisfaction; as such we can acquire new customers from words of mouth. We have adopted a complete attitude of commitment among the workers in order to have stable relationships with customer.

ENT 1: We have developed the company’s reputation with all of our stakeholders, particularly our customers, suppliers and the people around. We believe in being transparent in the relationship.

The responses of two SME entrepreneurs on the subject of relational capital were rather conservative, which suggests that they have less comprehensive knowledge of the company’s activities in this dimension. Furthermore, intensified competitions in the business have created self-initiated barriers for the interviewee to engage in collaboration with external stakeholders, mainly those who were perceived as potential competitors. This has been illustrated in the following example.

ENT 3: I do have relationships with other companies but that is really a big challenge as each of us is very much hang on to what we have got...there is a fear of working together most of the time.

Moreover, SME entrepreneurs found that it was quite hard to gain trust and cooperation from their external parties.
ENT 3: If you get your supplier to trust you then you will be ok...emmm...the supplier will be reluctant to give us the materials especially when the previous payment is not been made. We were waiting for the LO (local order) disbursement.

Theme: Islamic work ethics
One of the entrepreneurs put forward the implementation of Islamic work ethics in business dealings commencing from the financial management which is related to the acquisitions and expenses.

ENT 2: To practice Islamic work ethics, I ensure that all sources of income and expenses of the business are in line with what Islam has taught. I used my own savings and family savings for my business initial capital...when I first started this business. But sometimes...I mean recently...I was very desperate for financial capital...and I made a loan with a bank. I chose Islamic bank, though.

ENT 1: We should always be patient with customer demands and comments, we should not cheat our customers and avoid ‘duit haram’ (illegal profit) [...].. When I build a house for my customer, I always imagine that it is the house that I will live in, so I will say to myself...If I am happy to live in it, that means my customer will also be happy.

ENT 3: I do not know Islamic work ethics very well, but I can guess in general term...to be just, generous, keep promises and hardworking. Do not be arrogant towards people even though we have successful business.

The responses above suggest that the entrepreneurs have a good idea of Islamic work ethics and follow the teachings of the holy prophet Muhammad SAW. The prophet admonishes good business dealing habits and abhors unethical business decisions and practices.

DISCUSSION

In the document analysis, it can be said that ENT 3’s investments on a new sophisticated printing machine and increased number of skilled staff would generate more profits in the future. The company had actually elevated its human capital (i.e. by increasing the number of skilled staff), technological capital and organizational capital (i.e. by purchasing a new sophisticated printing machine) and relational capital (i.e by having better relationship with supplier, customers and employees). Hence, it is anticipated that ENT 3 would gain value creation in the years to come because IC establishes foundations of future competitiveness (Jardon & Martos, 2009). IC is indeed more important as a source of competitive advantage in SMEs than large companies because tangible resources were normally lower and SMEs must compete through intangible resources (Jardon & Martos 2012). ENT 3 had actually been doing the right thing.

In brief, SME entrepreneurs realised on the need to maintain a competitive advantage through extracting value from IC and IWE. As manifested in the interview session, the entrepreneurs highlighted their concern with management of the company’s networks. They failed to gain trust and commitment from shareholders, customers, suppliers and community. Therefore, SME entrepreneurs should accentuate on constructing easier communication process to ensure that their business values and norms are shared to relevant parties, enhance network ties and develop a close network, which is necessary in postulating access to resources and knowledge. This, in return, is expected to improve business performance. The concept of management by example in upholding Islamic work ethics have made the employees happy and customers satisfied, which resulted in business profitability (Abbasi, Rehman & Bibi, 2011). SME
entrepreneurs who acted as role models could influence others to follow corporate objectives enthusiastically.

The result also determines that SMEs can develop dependable managers or entrepreneurs and reliable employees through inculcating and internalizing IWE in the working environment of the organization in order to achieve business profitability. Moreover, in the interview, ENT 1, ENT 2 and ENT 3 claimed that they had removed any unlawful activities and devoted to lawful activities which benefit mankind. These Bumiputera entrepreneurs endeavoured to emulate the excellent example of prophet Muhammad SAW, a renowned entrepreneur who was known for his ethical business dealings, by upholding the sanctity of Islamic work ethics.

Additionally, the documents analysis disclosed that ENT 3 had weak financial health, hence creating marginal intellectual capital. The company had invested a lot of money in human capital and organizational capital by buying new technology and sending their employees to learn new processes and technical skills. On the contrary, the results from interview uncovered SME entrepreneurs’ positive concerns on organizational capital. They claimed that the exposure of technical parts from previous employment had given an insight of how to improve their work processes and handle any issues related to technical problems.

In term of human capital, the interviewees (ENT 1 and ENT 3) had the opinions that university education was not a contributing factor to entrepreneurship. They believed they had not developed skills and knowledge which were directly relevant to entrepreneurship. Sometimes, they saw university as not being helpful in establishing their businesses. This finding further supported the idea of Coy et al., (2007) who had asserted that holding a higher level of educational background did not necessarily contribute to a firm’s success. It is well highlighted that the Malaysian richest Bumiputera entrepreneur, Tan Sri Syed Mokhtar Al-Bukhary, has never had tertiary education and studied only until form five. He is a symbolic figure who upholds the philosophy that education does not guarantee success in life as opposed to hard work, and he is a walking proof of that. But, it does not mean he lacks knowledge since he becomes knowledgeable and proficient through his own entrepreneurship endeavors during his adolescence years. However, choosing to pursue the education route and knowledge is a useful way to progress and understanding the inner workings of a business, and could play a crucial part in driving business forward. In reality, higher education enhances flexibility, openness and independent thinking of ENT 1 and ENT 3 without them even knowing it. Thus, this study argues that higher level of education may have a pronounced effect on SME entrepreneurs because advanced element of education might favour both a better understanding of the more complex nature of entrepreneurial opportunities and the objective of profitable business. Besides possessing firm-specific knowledge, skills and abilities, SME entrepreneurs with higher education would also become the sources of new ideas for the enhancement of business performance.

CONCLUSION

This study was motivated by the lack of ability among SME entrepreneurs to become more resilient and competitive in the local and global open market. If SME entrepreneurs wish to influence the performance of their companies, the areas they should emphasize are human capital, organizational capital, relational capital and Islamic work ethics. Further, SME entrepreneurs should extend practices of Islamic work ethics to employees, customers, vendors, partners and the communities by building a positive environment founded on trust and commitment.
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