

THE IMPORTANCE OF CAPITAL IN ECONOMIC THEORY: A BRIEF REVIEW OF THE INTELLECTUAL CAPITAL IN M&AS

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Summary: *As a result of the permanent changes brought by globalization, emerging technologies and the shorter lifecycle of products, knowledge and innovation have become the main competitive advantages of many companies. Small and medium-sized enterprises must also constantly adapt to the changing economic environment and identify the relevant solutions to respond to these changes. Innovation based on market movements, transparent structures and the strategic development of key competences of companies, operating in the private environment are prerequisites for sustainable development and competitiveness. Using M&As, the acquiring companies have the possibility to access intellectual capital and innovation, belonging to another company, by merging or acquiring the target that owns certain resources. This paper presents a brief history of the term capital, followed by a statement of intellectual capital which can be used by companies involved in M&As to assess the intellectual capital of the acquired company.*

Keywords: intellectual capital, economy, M&As, performance.

JEL Classification: B15, G34, O34

Introduction

The term "capital" appears frequently in most areas of activity. Whether we are talking about people, businesses, communities or society as a whole, this term can be related to elements present in everyday life. The notion of capital is related to the capitalist enterprise, whose functionality is valid in the socio-economic organization. The entrepreneurs (composed of persons and economic entities) provides the capital necessary for the development of production, in the conditions in which companies produce goods or services by employing people.

In the broadest sense, capital is "one of the factors of production (alongside labor and land) that can be defined as a wealth used for production" (Pântea and Pop, 2004: 39).

The notion of capital, in a strictly economic sense, first appeared in the 12th century and circulated in various ways: as a fund, commodity stock, money, etc. In the 14th century, the term capital evolved to wealth, money wealth, funds, etc. (Bucătaru, 2006: 45). Moreover, until about 400 years ago, capital was ignored in the British writers' economic work, as we shall see, in the history of this concept. In fact, the word capital is not mentioned before the year 1600. In the next hundred years, we still do not find information about capital, except as a reference to investments such as financing commercial campaigns in East India Companies. Overall, since its inception, the term "capital" has been associated with the idea of "money investment", a concept present today in... laymen terms.

1. Structures of capital in Economic Theory

An incursion into the evolution of the capital term seems welcome, as it underpins the current concept, which is very complex. In addition, alongside the economic writings, different structures of the capital concept are found, depending on the economic thinking of that time and the evolutionary state of the economic context and of the enterprises.

At the risk of omitting some less important presentations, we consider it appropriate to begin this evolution with Adam Smith's "An Inquiry into de Nature and Causes of the Wealth of Nations" (1776), in which we find, with the specific errors of the moment, a first structure of capital. According to the author, although the division of labor was the mechanism by which national prosperity

emerged, it was first necessary to accumulate capital (Smith, 2011: 26). Adam Smith speaks of a stock of materials that a producer needs to own in order to start any form of business. Smith also presented a first form of investment, considering that the stockholder may be another person. We cannot not to notice the relatively unclear use of stock / capital terms, as capital is only part of the stock, from which an income is expected.

Smith observed that the combined stocks of the company - or its capital - can be divided into three components:

1. Immediately consumed stocks, including housing. People mistakenly believe that their home would be a “capital”, Smith observed, but unless it is rented to someone else, it cannot be described otherwise, as it does not generate any income or profit. In fact, it is a cost;
2. *Fixed capital*, which produces income or profit, regardless of who owns it. Fixed capital includes: machines or tools of the profession; owned and rented buildings; improved land that can produce a harvest, and capable and skilled workers whose knowledge can be used productively. The size of the segment of such workers can determine the wealth of a nation to the same extent as the size of its arable land;
3. *Circulating capital*, which includes: money through which other forms of capital can easily pass from one person to another; freight reserves, ready to be sold; materials - or those assets needed to make the goods that are in the hands of the suppliers and the products that are in the warehouses, waiting to be bought. This capital moves away from one merchant in a form and returns to another; only through this movement it can generate profit (Smith, 2011: 170-171).

Any confusion was accepted and understood, considering that the period belonged to the commercial enterprise, and industrialization, with an emphasis on factories and machinery, was in an early form. However, Adam Smith is acknowledged to be the first to carry out an analysis of the place of capital in production. Although he considered labor to be the source of value creation, he was also the one who saw the direct link between the number of available workers and the capital held. Consequently, any increase in the number of workers should only be accompanied by an infusion of capital.

The modern content of the capital term belongs to the physiocrats, being introduced by A.J. Turgot (1727-1781) in the 18th century. In the view of the French economist, theoretician of economic liberalism, the notion of capital meant more than money or goods, it actually meant a value that contributed to the production of new values and profit. Later, other economists have reported on this concept and they have developed it. In the context, the notion of capital evolved, being related not only to the value of the money detained by an entity but also to the assets owned by it, and more recently to the employees seen as a form of intangible capital that add value using their skills.

The first criticisms of Smith’s theory, as alternative explanations of the function of capital, belonged to Lord Earl Lauderdale VIII and were published in 1804 in “An Inquiry into the Nature and Origin of Public Wealth and into the Nature and Causes of Its Increase” (Cole, 1956: 115-125). He saw capital as a stand-alone factor, productive by itself. In his view, capital either supplanted a certain amount of work or intermediated services that labor could not fulfil. Regardless of the approach, the capital itself was productive.

F.B.W. von Hermann (1795-1868) may also be considered a critic of Smith, although he supported much of his theories. In the paper “Staatswirtschaftliche Untersuchungen”, published in 1832, he superficially structured the capital in working capital and industrial capital, the latter being, in turn, split in borrowed capital and productive capital. His unique contribution to the development of the capital concept is that he first considered land as capital, being a sustainable source of income. It should also be noted that in his writings, von Hermann considered capital distinct from other forms of production factors.

The popularization of Smith’s writings belongs, as himself admits, to Jean-Baptiste Say (1767-1832). In “A Treatise on Political Economy”, one can see both an acclamation of Smith’s work and personal points of view (Say, 1855: 14-46). In relation to the concept of capital, it is noticed that Say used it confusingly because, in some places, the concept comprises of goods used in production, and elsewhere, capital constitutes the enterprise funds. We can assert that it is one of the first complex approaches of capital, both as a sum of goods and as a sum invested in the business. Regarding the

owner of the capital, the entrepreneur, if in Smith's vision was non-existent, J.B. Say was the one who bought him into attention, as a motor for private development.

A landmark in the evolution of the capital concept, from the perspective of classical economists, is represented by David Ricardo (1772-1823). In his attempt to discover the laws and results of the free and competitive economic environment, in his work entitled "Principles of Political Economy and Taxation" (1817), he considered capital as stored work (Sowell, 2006). Later, in 1820, in "The Work and Correspondence of David Ricardo, Vol. 2 Notes on Malthus", he reverted to the concept of capital, which he considered part of the accumulated wealth to be used for profit (Ricardo, 2005: 162).

A similar opinion is also found in John Stuart Mill (1806-1873). In his opinion, economic development is a function of land, labor and capital. While labor and land are incipient factors of production, capital is a stock, previously accumulated from the production obtained through labor. Growth of wealth is only possible if land and capital help to increase production faster than labor, the capital is the result of saving, and the latter is the result of abstinence from the present consumption, for the benefit of the future.

Traveling in time, we find Frédéric Bastiat (1801-1850), a representative of the liberal school. He mainly wrote in the 1840s, starting from the same premise, of labor stored in capital, but he also showed how its value is continually decreasing. The continuous increase in labor productivity leads to the possibility of producing, next year, an element of capital at a lower cost of labor. Of course, his theory also has shortcomings, including the motivation to increase labor productivity.

Johann Heinrich von Thünen (1783-1850) added the theory of capital to the concept of diminishing productivity. Starting from the same definition of capital as work stored in production in "The Isolated State", the idea behind it is that natural income is a radical of the multiplication between the result of capital/labor use and the level of subsistence of the producer. Recognized for its agricultural work, it should be noted that the reference to capital only refers to its contribution as a factor of production.

One of the most extensive capital-related works belongs to Eugen von Böhm-Bawerk (1851-1914). His paper, "Kapital und Kapitalzins" (Capital and Interest), is a critique of the history of capital theories and a presentation of his understanding of the subject. The idea from which he started is simple: the future values of the present goods are lower than the present values. Man, by his nature, does not anticipate his future desires, to the point where present goods have a higher value than the same goods in the future (the concept of preference over time). Just like Bastiat, he believes that goods are now more valuable due to more productive capital. Including Von Thünen's theories (declining profitability) in his own, Böhm-Bawerk offered a vision close to the present one for the term capital: apart from the substance of capital, its use is independent from its nature and value (Von Böhm-Bawerk, 1884: 13-33). The value of a product is given by the sum of the values used to produce it, on the one hand, and, on the other hand, is equal to the substance of the capital and its use. Hence, the value of the product must exceed the substance of the capital. The best example is that of a fisherman who, for 100 days, makes a net, and in the next 100 days he catches 500 fish with it. Another fisherman catches three fish a day for 200 days, without a net. Now, considering the exploitation of capital, in 200 days of work, the first fisherman caught 500 fish and the second fisherman 600 fish. According to the capital use theory, the net has interest, and its use adds up to 200 fish for the 100 days of use. So, the substance of capital cannot be dissociated from its use, an idea that has been perpetuated to this day. Obviously, today's economist would ask an important question: why, at first glance, the second fisherman is more efficient?

The next representative stage in the evolution of the capital concept is represented by the work of John Maynard Keynes (1883-1946) and his revolt against classical doctrine. According to his opinion reflected in "The General Theory of Employment, Interest and Money" (1936), Keynes believed that, at some point, capital supply would be greater than needed. His explanation is very simple: the decision not to spend today does not necessarily translate into the decision to spend tomorrow or at a specific date in the future (Keynes, 1936). The consequences are: the current consumption is not stimulated, nor does it prepare the enterprises for any future consumption - like a substitution of present consumption with the future one; it is just a diminution of the present demand. In addition,

future consumption is estimated on the basis of current data, making a reduction currently impacting future actions negatively. The outcome? A present economy affects current consumption, influencing expectations of future consumption, which in turn has a negative impact on employment. The idea that the individual savings have an equally good influence on demand as individual consumption is false and is based on the wrong conclusion that the desire to save is the same as the desire to invest. By increasing the demand for investment, the production is stimulated, and current investment is influenced by the individual savings to the extent that consumption is diminished. In this context, the expectation of individuals for a future return should not be ignored (the increase of the value of an investment). As future yield depends on demand, diminishing current demand will make the current capital supply too high. Moreover, the idea of being paid for “waiting” has no foundation, because waiting or abstinence from the purchase does not produce and does not guarantee future value creation.

Through this capitalist attitude, Keynes responded to another great economist who discussed the capital issue, William Nassau Senior (1790-1864), and whose theory is diametrically opposed to Keynes's. In his work published in 1836, “An Outline of the Science of Political Economy”, he expressed the view that abstinence leads to the most sophisticated capital accumulation. Withholding from current consumption in order to accumulate capital supports future production (in the previous example of the fisherman, the direct method of production is to catch fish by hand. But if the fisherman postpones production enough to produce working capital, he will catch fish in a faster rate than the simpler but more efficient method). But since capital goods do not directly satisfy consumers' desires, the sacrifice of postponing consumption deserves a reward, which he calls “interest” (Nassau Senior, 1836: 153-159). This idea represents his great contribution to economic theory.

An unusual idea of capital, especially the circulating one, if it is to refer to the structure of capital (fixed and circulating) present in most classical writings, belongs to J.C.L. Simonde de Sismondi (1773-1848). According to the author, the introduction of new machinery should lead to the social goal of creating new jobs. If, however, it cannot meet this goal, at least it should not replace the human workforce with the automated workforce. In the view of this critic of capitalism, economic life is a war of machines against humans. Later, Vladimir Ilyich Lenin (1870-1924) later claimed that Sismondi delimited the capital from the income, stating that the first is used in production and the second for consumption. But in an economic context, the discussion is about society and society also consumes fixed capital. The distinction between the two fades, and the economic and social process that transforms the capital of one into the income of another is still unexplained (Lenin, 1897: 129-266).

Sismondi's point of view is found in a more elaborate and much more grounded form in the theoretical economy in the writings of Karl Marx (1818-1883). As he himself states, “The circulation of commodities is the starting-point of capital. It appears only when the production of commodities and commerce have already attained a certain degree of development. The modern history of capital dates from the creation, in the 16th century, of a worldwide commerce and a world-wide market” (Marx, 1867). By selling the goods produced by workers on the market, the employer is able to acquire additional labor (which take the form of capital). This process is a continuous process that “incorporates living labor into dead substance” (Marx, 1867), capital becoming a living, prolific and multiplying monster. The new capital is used to exploit live labor. Although the new capital leads to an increase in labor productivity, the employee wage level does not increase, with the surplus of value reaching to the employer. Marx does not condemn capital, but the fact that the private enterprise allows the employer to assume the surplus value obtained with the capital. We observe a similarity with David Ricardo's stored work theory.

The presentation of the evolution of capital in economic history provides an answer to its structure from the beginning to the present. As a conclusion, we note that the doctrines, in most cases, do not have a clear view of the content of the concept. The clearest structure is the one referring to the physical form (fixed and circulating), seen as one of the pillars of production. The financial side of the capital also makes its presence felt, with some gaps in interest and the surplus resulting from the still uncertain profit.

What we can safely conclude is that, with regard to the history of the term, capital takes two forms: physical and financial, leaving open approaches.

2. Intellectual capital – a new stage in the evolution of capital

At the end of the 20th century and the beginning of the 21st century, a new form of capital “invaded” both the specialized papers and the world of practitioners - the intellectual capital (IC), in response to the awareness that the main, if not the only, wealth-producing resources had become the information and the knowledge.

The emergence of IC was definitely linked to the more interest-bearing communication of the word knowledge, and it was proposed as a form of manifestation and reporting by the management. When we refer to reporting, we are considering presenting the size and the development of a number of resources that are found in companies: employees, customer relationships and technology, whether it is purchased or produced. The new economy implies giving a heightened interest to the knowledge society, to the employee with knowledge, to the IC, and to the learning organizations. Economic capital remains an important factor in the production of goods and services, but its importance is decreasing as intangible assets based on knowledge are imposed.

Over time, knowledge has become the key, but unfortunately also the ambiguous resource of the society (Mouritsen and Roslender, 2009). Unlike labor, land and capital, it is an asset that appreciates by its use. The more it is used, the more effective and efficient the knowledge becomes. In Sveiby’s (1997) opinion, in the new economy, knowledge has four characteristics: it is tacit; is action-oriented; is based on rules; is constantly changing.

Therefore, the relatively new and extremely discussed term of knowledge society has generated a wave of interest for IC. But the mere awareness of his existence is not enough. The purpose of understanding IC and its essence is precisely the identification and follow-up of learning organizations, in order to ultimately understand the way in which these entities develop but also to regulate a form of reporting, as a result of exploitation.

Making 21st century companies aware of IC information is a direct consequence of the resource-based theory of competitive advantage (Grant, 1991; Hitt *et al.*, 2016; Alvarez and Barney, 2017). This theory states that the company is a collection of material, financial and intellectual resources, the development and performance of a business being ensured by their use (Neagu, 2007). In some authors’ opinion, the resource-based view advocates that the most valuable resources, which generate competitive advantage, are intangible resources. In this context, managers should not report their IC to their competitors because, doing so, would more than likely hurt, rather than enhance their competitiveness (Dierickx and Cool, 1989; Dumay, 2016).

There is no unanimously accepted definition of intellectual capital, although no one can say that the mere mention of this notion does not bring into the foreground a series of concepts, all valid in its definition: knowledge, information, people, employees, image, stakeholders, clients, relationships, intangibles, patents, technologies, etc.

One of the most relevant definitions belongs to Brooking (1996) and states that, in an organization, IC is the term of the combined intangible assets that help a company to function. Another definition states that this capital is the formalized intellectual material, captured in a regulated form and used to obtain higher value assets (Stewart, 1994). Three years later, the same Stewart stated that the IC is useful and “packaged” knowledge (Stewart, 1997), which requires an identification of the intangible elements that compose it.

Because of its complexity, the IC is difficult to define by a simple phrase. Therefore, many authors prefer to describe IC through its components (Wall *et al.*, 2004; Stewart, 1994; Andriessen, 2004). The most frequent structure of intellectual capital comprises three components, as follows (MERITUM, 2001):

A. A component is made up of people or *human capital*. We can define human capital as the sum of the skills, abilities, talent, knowledge and expertise of employees, the knowledge they have when they leave the company at the end of the day, specifying that there must be a distinction between the

individual expertise of the employees and the collective ability of the company to exploit this capital (Arsene, 2010). This knowledge can be unique, individual, or generic.

B. Another component is what surrounds people in an organization, namely *structural capital* - all intangible assets left behind when people go home, internal processes and structures, patents, databases, all documents that attest the know-how of a company.

C. As a third part, we consider processes and external relations, customer relations and the image of the company, called *social capital (relational)*.

Although defined in other words, the essence and denomination of the three components of IC are found in most of the papers addressed to this field (Alcaniz *et al.*, 2011, Beattie and Thomson, 2007, Garcia-Meca and Martinez, 2007; Gowthorpe, 2009). In particular, we mention here the approach of the authors Sánchez *et al.* (2007), whose studies on intellectual capital in universities, find the structure: human capital, organizational capital and relational capital, with definitions similar to those already mentioned.

3. The M&As and the importance of intellectual capital

Using the IC perspective, a synergy can be defined as the interaction of two or more intellectual capital resources from previously sovereign organizations, that creates an enhanced combined effect to value creation and competitive performance, which is greater than the sum of their individual effects (Gupta and Roos, 2001).

Key to synergy realization are the required resource interactions. Considering the possibilities of exchanging the intangible resources between companies, there are three mechanisms for trading them, as a result of M&As:

1. **Transfer.** The transfer of intangible resources between acquirer and target has to generate future economic benefits for the concentration, as final result. Thus, the transfer implies to give or take the resources, so as to be leveraged more efficiently and effectively.
2. **Share.** The sharing of a resource by the firm that deploys it (either the target or the acquirer) can generate future economic benefits for both entities involved in the concentration.
3. **Teach.** Teaching entails the replication of the resource under the guidance of its present deployer involving teaching and learning activities.

In a large number of mergers and acquisitions, a significant proportion of the deal value is paid for IC. Taking this into account, this area offers great opportunities for further research into the process of how organizations assess their IC or the one offered by the target, in a merger and acquisition context. Limited access to the IC of potential target firms in a M&A context makes the process difficult for the acquiring firm as well as for researchers (Marr *et al.*, 2003). Thus, managing their specific 'intellectual capital' (IC) becomes increasingly important for future-oriented organizations. Current balance sheets and controlling instruments are not sufficient anymore, because intangible assets are not taken into consideration by conventional methods.

What are the possibilities for the companies involved in M&As to report their IC? Better disclosure of IC would make these processes easier, which links this field into the work on corporate reporting of IC. Given this necessity, Mouritsen *et al.* (2001) as well as other researchers were involved in the EU Meritum project on managing and reporting intangibles. Later, the European Commission proposed the Intellectual Capital Statement (InCaS), as an alternative (European Commission, 2012). In July 2006, InCaS started as part of the program "Collective Research" funded by the European Commission, DG Research. The project counted 40 participants from 8 countries and brought together scientists, entrepreneurs as well as IAGs (Industrial Associations/Groupings). The result of this project was the statement presented in Figure 1.

Basically, these steps can be delimited as follows:

- Step 0 includes the company's history, culture and background. It also refers to additional information on strategy, market development, trends, etc. In order to follow the next steps, a management team is formed which has the role of following the steps 1-5 and completing the required situation.

• Step 1 asks for a presentation of how the company creates value, starting from the products and services it sells and ending with the main processes in the business. The answer to these questions must concern the enterprise as a whole or just a segment.

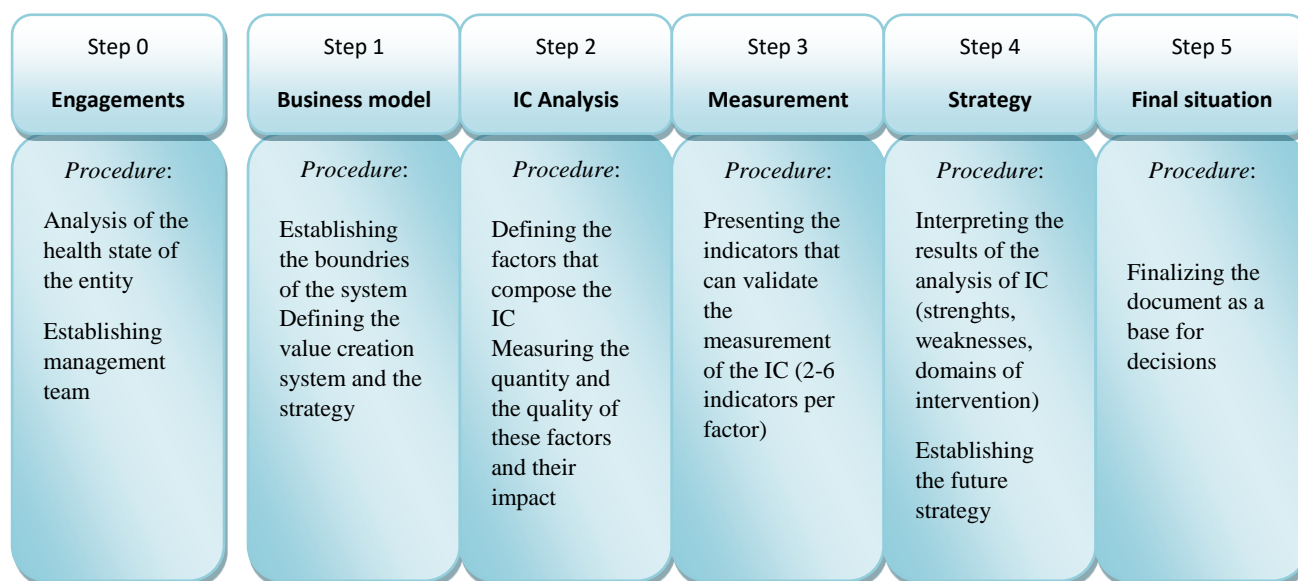


Fig. 1. InCaS - Intellectual Capital Statement

• Step 2 concerns the analysis of the three components of intellectual capital, but also the identification of those factors that actually compose them. The level of detail must be high. Also, the factors are analyzed in terms of strengths and weaknesses. In the case of factors such as organizational culture, very important in the post-M&A integration (Bligh, 2006, Brueller et al., 2016), the quantitative-qualitative delimitation is low, so they will be treated as a single dimension and described as such. For each of the identified factors, three questions have to be answered:

1. Is the amount / volume of this factor sufficient to achieve the strategic objectives? (quantitative question)
2. Is the quality of this factor sufficient to achieve the strategic objectives? (qualitative question)
3. Are there clear measures defined, in order to improve this factor? (managerial question). The answers to the three questions are on a scale of 0-100%, where 0-30% is "insufficient", 30-60% "partially sufficient", 60-90% "sufficiently enough" and 90-100% "absolutely sufficient".

Thus, for each factor, for example organizational culture, the question "How does organizational culture respond to strategic objectives?" is given, the percentage of 85% is offered and a reason for this percentage is given. Finally, the factors, grouped on the three components of the intellectual capital, are synthesized in a table, which includes the question, the percentage and the reason for the evaluation. In this way, for each component of intellectual capital, a result for sufficiency is obtained, in total and in components.

It is also recommended to analyze the impact score of each factor, as presented in Table 1:

Table 1. The impact score of the IC components

IC Type	ID	Factor	The calculation made by each team member								Amount	Impact score
Human capital	HC1	Professional competence	5	1	3	2	2	7	3	3	26	7,20%
	HC2	Motivation	4	3	2	5	3	8	2	5	32	8,90%
	HC3	Social attitude	9	5	5	8	5	5	5	6	48	13,30%
Structural capital	SC1	Culture	7	6	8	6	7	2	8	8	52	14,40%
	SC2	IT	6	9	6	9	9	1	9	7	56	15,60%
	SC3	Know how, patents, rights, intellectual property	1	7	9	4	6	4	6	4	41	11,40%

IC Type	ID	Factor	The calculation made by each team member									Amount	Impact score
Relational capital	RC1	Relationship with customers	2	8	4	1	1	6	7	1	30	8,30%	
	RC2	Relationship with investors	3	2	1	3	4	9	4	9	35	9,70%	
	RC3	Relationship with environment	8	4	7	7	8	3	1	2	40	11,20%	
Total			45	45	45	45	45	45	45	45	360	100%	

Source: Comisia Europeană, InCaS: Intellectual Capital Statement. Made in Europe, disponibil online la adresa <http://www.incas-europe.org/European%20ICS%20Guideline.pdf>, p. 32

Each factor is given a score of 1-9 (the total number of factors). On a horizontal basis, the total scores of each team member are calculated and the percentage of importance is given, which may also result in a classification of the factors, depending on their importance and impact.

- Step 3 calls for effective indicators of quantification of intellectual capital, representing the factors taken into account. These indicators can range from information in absolute size (number of employees, number of managers, number of patents and trademarks etc.) to indicators with relative sizes or qualitative assessment, made using 1/0.

- Step 4 repeats the percentages of the three questions in step 2 and averages them, representing the "average value" of each factor, the difference up to 100% representing potential for improvement. It is also possible to calculate the average for each component of the intellectual capital.

Finally, the portfolio of intellectual capital management is graphically presented, on the abscissa X being passed the impact score, and on the ordinate the average of the questions in step 2. The obtained quadrant is divided into four parts:

1. Left bottom - Analysis - includes factors of minor importance for strategic objectives, but with great potential for development;
2. Bottom right - No action needed - includes factors of minor importance for strategic objectives but also with low development potential;
3. Top left - Development - includes factors of great importance for strategic objectives but also with high potential for development;
4. Top right - Stability - includes factors of great importance for strategic objectives, but with little potential for development.

This graph is a map of the intellectual capital and strategic development factors of the enterprise, directly related to these factors.

All these conclusions must be processed, in Step 5, in a Situation of Intellectual Capital, in two variants, internal and external, in order to respond to the needs of interested stakeholders.

It is obvious that such a situation of intellectual capital can only be achieved within a firm and never based on public information. Therefore, access to such a document can only be made by contacting the persons directly involved in the entity, the report itself being a managerial product.

Conclusions

Intellectual capital must become an important part of firm strategies, including in the M&As. Its components must be identified and exploited to their true potential so that both the acquirer and the target company benefit from the maximum future benefits embodied in them. In addition, companies need to understand that employees, as well as human capital, are easily identifiable and there are extremely varied ways of motivating them, either financially or through social attitudes. Based on the above, we believe management should consider that the novelty of intellectual capital and its insufficient regulation represented and represents for both practitioners (including managers) and the academic community a challenge in terms of quantifying the economic benefits expected from exploiting this capital.

The dimensions of management's involvement in intellectual capital management have multiple attributes, and the tools available to it become more and more complex. Regardless of the methods chosen to reflect, measure or present intellectual capital, it should not be forgotten that the assessed elements are knowledge-based, therefore they have a high degree of subjectivity.

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