



RESEARCH ARTICLE

**A RESEARCH REPORT ON ACCOUNTING FOR INTANGIBLES: THE  
PROFESSIONAL INDIFFERENCE AND STATE OF DISCLOSURE**

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ABSTRACT

**Article History:**

Received 2nd Oct- 2017

Received in revised form 29<sup>th</sup>

Oct 2017

Accepted 25.11.2017

Published on 30.12.2017

**Keyword:** Intangibles,  
Disclosures, Content Analysis.

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*Intangible Assets are increasingly major component of the total assets of firms as firms move from manufacturing and industrial activities towards services and knowledge-based activities. Relative to the other components of a firm's assets such as physical and monetary assets, Intangible Assets are more difficult to define, measure, manage and value. Yet given the profound importance of such assets to firm's competitive advantage and value creation capabilities, serious attempts need to be, and increasingly are, made to establish clear definitions, measurement rules and valuation principles. Thus today, the great values exist in assets that are one of a kind, that make companies unique. The problem is though to determine a value for these assets, since this value mainly exists as future potential for creating value. Further as these intangibles by their nature cannot be seen or touched, they only exist as long as someone believes they exist, and they only have a value as long as someone can use them correctly together with other assets to create value. This study is concerned with the fact that our measurement methodologies are inadequately aligned. At the moment it seems there are insufficient pressure points to inject real momentum into changing the face of corporate reporting. It has been argued that a nexus of intangible assets, quasi-assets and competences in the form of unique or distinctive capabilities deriving from innovation and knowledge are now essential ingredients of the economic production process which are still poorly understood and measurement methodologies have not kept pace. This can be traced partly to our existing accounting-based systems, which are unable to produce routine, systematic information on the ongoing changes in the corporate and social asset base.*



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### **The Thrust**

This paper is an offshoot of my recently completed (under evaluation for the award of Ph.D degree) research “Accounting for Intangibles – An Exploration”, the focus being on accounting methods for valuation of Intangibles, current policy trends and voluntary disclosure practices.

### **Environmental Dynamics, Accounting & Intangibles**

The economic, social, legal, political, and other environments keep changing in a country as time passes and accounting systems have to be in tune with these changing environments. Socio-economic environment in particular has a great influence on accounting structures and processes. For the past two decades accounting has been regarded as a system that provides information to the users. An exceptional durability of accounting for over 500 years is being severely tested by the New Economy, characterized by the fast pace of technological change and the consequent increased uncertainty, the substitution of intangible for tangible assets as the major drivers of value, and the blurring of the boundaries between the firm and its customers, suppliers and even competitors.

In bygone mercantile and manufacturing economies most value was tangible; comprised of land, building, equipment, inventory, or financial assets; stocks or bond and the like. In today’s economy, much value, perhaps new value is intangible and can’t be accounted for as traditional accounting tangibles. From the above discussed factors one important question arises what are intangibles?

That no generally accepted definition of intangibles exists should come as little surprise. After all, such assets, unlike machinery and inventory, are not

something a manager can kick, move and count. Nor do intangibles show up in any systematic way on the balance sheet, the profit-loss statement or cash flows. Intangibles, in other words, are not only intangible; they are largely invisible in relation to standard business management tools and disclosures.

An intangible asset is a “*claim to future benefits that does not have a physical or financial (a stock or bond) embodiment.*” *Intangibles can be divided along three major nexus, “distinguished by their relation to the generator of the assets: discovery, organizational practices and human resources.”*

Intangibles are “*nonphysical factors that contribute to, or, are used in producing goods or providing services or, that are expected to generate future productive benefits for the Individuals or firms that control the use of those factors.*”

Two key threads in these definitions are non-physical and knowledge-rooted. Intangibles are rooted in human capabilities and are manifested in the relationships and the profile of organizations. They are assets that depend first and foremost on human creativity, not materials, and are transformed into enduring value for organizations by building know-how, capacity to innovate, and forming alliances and networks—all which lead to enhancing brand and reputation. In less technical terms, intangibles have been described as the assets of an organization that remain after plant, equipment and inventory is sold, the lights have been turned off, and doors locked.

### **Intangibles the Key Value Driver of Modern Times**

Of course, intangibles by this definition have always played a role in value creation. From the earliest years of the Industrial Revolution, innovation has been



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the key driver of value, dating from the invention of the steam engine and onward to large-scale factory automation based on specialization of labor. But what eventually separated the winners from the laggards in the beginning of the 20<sup>th</sup> century was not scale of operations, but technical and organizational innovation. Scale followed, of course, in the case of automobile manufacturing, petroleum and telecommunications; but the root of the success was the capacity to envision systems, networks and markets sooner and clearer than the competition.

Thus intangibles are “something that cannot be touched, easily defined, formulated, or grasped.” Clearly, enterprises that invest in intangible assets expect to obtain probable future economic benefits from the economic investments; otherwise, they would not expend resources on them. Intangibles are thus envisioned tools as one of the most influencing value driver.

Above factors clearly indicate that the role of accounting is fast changing due to changes in the environment. Consequent, upon the liberalization and globalization, accounting standards are being internalized to play an effective role by providing comparable information to global economies. Besides above factors, development in quantitative methods and behavioral sciences has shifted the focus of interest to decision making. Thus accounting has become an inter-disciplinary subject and multidimensional in nature. Accounting therefore, should become an overall system that measures and directs the performance of all components of an organization.

### **Intangibles-Changing Dimensions for Competitive Edge**

When today’s observers speak of the knowledge economy, the information economy and the services economy, such

descriptors reflect the continuing ascendance of intangibles as key value drivers in the modern corporation. Competitive advantage resides in the minds of managers far more than the portfolio of physical assets of the organization. One need only observe the price-to-earnings and/or market-to-book ratios of companies like Microsoft and Google to see domination of intangibles in contributing to standard measure of value creation. And companies like Dell and Wal-Mart are sector leaders not because of scale per se, but because of their superior capacities to innovate in the areas of process improvements and logistics. Capacity to innovate—among the most potent of all intangibles—enables growth.

The capability of companies to create economic value, i.e. customer value, shareholder value, and stakeholder value, is increasingly dependent on intangible assets – on immaterial resources and production factors. Today, intangible assets are predominantly responsible for a company’s capacity to innovate and thus for its capability to create added value in a highly dynamic, highly competitive global business environment and to “make a difference”. And that is the very problem: our enterprise management concepts and control instruments have failed to keep up with this development. They provide a too narrow angle, and exclude the most important factors of production of our companies and economies of today, which are increasingly knowledge based and service oriented; the intangible assets along with their intrinsic production forces and risks.

### **Intangibles: A Concern of Reporting and Accounting Research**

Accounting academics, regulators and other major stakeholders are grappling with the trade-off between the relevance of external financial reports and maintaining



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the reliability and verifiability of the information provided. Pressure to expand reporting of intangible assets threatens the reliability and verifiability principles that underpin most accounting reporting frameworks, given the contingent nature of some intangible assets. Regulators are faced with a conundrum. They want to promote public interest and investor confidence by ensuring that financial reports are based on verifiable data. On the other hand, they want to encourage financial reporting that is informative to stakeholders and promotes efficient resource allocation. To date regulators have maintained a conservative approach to the measurement and reporting of intangible assets

The concern over the relevance of conservative reporting practices has generated a considerable amount of research investigating intangible asset related issues. The concern is that intangible expenditures comprise a large and growing proportion of total investment and operating expenditures but that this is not reflected in financial accounting rules and external financial reporting practices. An additional concern is the impact of financial accounting regulation on the design of information systems designed to support internal management decision-making. Microeconomic and Macroeconomic evidence provide support for the premise that the level of, and proportionate expenditure on, intangible expenditures have been growing. Furthermore, both the accounting and economics literature demonstrates the important information role of intangibles at the enterprise level. For example, a large number of studies show intangible expenditures and assets are relevant to firm valuation, including research and development costs (see Lev “Intangibles at crossroads”), patents, brands and trademarks, customer satisfaction, and

human resources (see Lev, 2001). However from an external financial reporting perspective, the evidence suggests that conservative accounting, which understates assets, reduces the quality of the financial statements and accounting earnings. This has flow-on effects for firm valuation.

The absence of intangible value in traditional accounting means that today’s financial statement lack relevance. The balance-sheet may state “shareholder equity” at a fraction or a multiple of the intrinsic, economic or market value of a company. The income statement may not be indicative of the economic or shareholder value added over the reporting period. Day by day public is rapidly gaining access to new and dramatically faster communication technologies. Entrepreneurs are able to draw on unprecedented scale economies and building vast empires, making great fortunes. As a result the government and public demand that these powerful new monopolists be held accountable under law. Every day there are new technological advances to which the old business model seems no longer to apply. Sure, today’s world is different in myriad of ways from that of century ago.

The development of these intangible activities has created a challenge before monitoring authorities. Current accounting (GAAP) does not convey relevant and timely information about the innovation process- business model-critical to the survival and success of business enterprises. Investment in discovery /learning is by and large expensed immediately in financial reports, and most investment items (e.g. Employee training, software acquisitions, and investments in web based systems) are not even reported separately to investors. The observation of recent corporate practices shows that value creating implementation stage of the innovation



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chain (like the case of drug approval, patent grant, or a successful beta test of a software product) is all but ignored by the transaction-based accounting system. And even the commercialization stage, which generates recordable costs and revenues, is generally reported in a highly aggregated manner, defying attempts to evaluate the efficiency of the firm's innovation process, such as the assessment of return on R&D or technology acquisition, the success of collaborative efforts, and the firm's ability to expeditiously "bring products to the market". Users cannot glean from financial reports the extent and success of firms "Internet involvement", a crucial survival factor in the new economy and a major component of the innovation process, as depicted in the fig. This failure to adequately reflect in a timely manner, important aspects of the innovation process is largely responsible for the decrease in the usefulness of financial reports.

Notwithstanding these trends, managers live in a world where intangibles remain under-recognized, under-managed and under-reported. While virtually every CEO is quick to point to human capital as the organization's primary asset, it is typically this asset that is first in the queue to feel the consequences of mergers and acquisitions. In government circles, measures of GDP are woefully inadequate in fully accounting for intangibles in national income accounts.

Difficulties encountered in trying to establish the real wealth and value of an organization has become a major challenge with the progress of the knowledge-driven economy. A new global economic order is emerging where the established norms of wealth-creation, investment and financial risk are called into question. As stated in a publication "ICT investment in the intangible economy", "The defining trend is

the shift from tangible to intangible factors of corporate value and competitive advantage and this, in turn, has led to the emergence of a discrete intangible economy in its own right"

#### **Reporting on Intangibles: Policy Trends**

There is a stronger demand for improved information on intangible assets from different categories of actors but there are still open debates and practical difficulties.

The Accounting challenge: knowledge is still in its early days and debate is much alive. Today, financial reporting does not provide adequate information on intangibles assets and does not reflect how much a company is worth. As mentioned in the above introduction, a recent British survey showed that, on average, 40% of the value of a company is not reflected in its balance sheet. For the accounting profession, the current accounting framework does not allow to account adequately for intangible assets, in particular for those internally generated intangibles.

However, there are some associated difficulties:

1. The majority of managers throughout the world still have a limited vision or an unclear perception of "intangible capital". Some surveys show that a majority do not understand the concept.
2. there is a standing paradox insofar as company managers believe that the management of intellectual capital is an important factor in determining future company success and competitiveness but in the same time few executives conduct initiatives within their



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- organization that are designed to assist in managing intellectual capital. The key components of intellectual capital are poorly understood, inadequately identified, managed inefficiently, and are not reported within a consistent framework.
3. Risks associated with IA disclosure result in some reluctance to disclose IA information, in particular externally (competitors, raiders, tax departments, suppliers). Companies are still extremely reluctant to use these for external reporting, due to strategic reasons and the possible tax repercussions of providing insight into intangible assets.
  4. Lack of methods and tools of companies to identify, understand and report on Intangible Assets.
  5. The cost to companies incurred in developing and maintaining information on Intangible Assets.
  6. From the companies' standpoint, it seems that internal reporting is better accepted by companies than external reporting because they recognize a value mainly for their internal management processes. In practical terms, it will only be possible to make new inroads with regard to external financial reporting if it is done as an extension to internal reporting. But ultimately, it may well be that pressure from external players

(shareholders, financial analysts and banks) will force the publication of this information, as the driving force behind this trend effectively shifts from business-internal to business-external factors.

7. Some manufacturing sectors though, especially the "low-tech", community, seem to stay away from these trends.

Keeping the above factors in consideration our research "Accounting for Intangibles: An Exploration" was concerned with the fact that our measurement methodologies are inadequately aligned. At the moment it seems there are insufficient pressure points to inject real momentum into changing the face of corporate reporting. It has been argued that a nexus of intangible assets, quasi-assets and competences in the form of unique or distinctive capabilities deriving from innovation and knowledge are now essential ingredients of the economic production process which are still poorly understood and measurement methodologies have not kept pace. This can be traced partly to our existing accounting-based systems, which are unable to produce routine, systematic information on the ongoing changes in the corporate and social asset base. Accounting community need to engage themselves more fully and obviously in a learning and experimentation process, with an understanding of the business model and its associated entangled and disentangled resources as its principal focus. An effort has been made to assess the relative effectiveness of different approaches to measure and manage these intangibles, which includes some criteria for the judgment of these approaches.

Thus in our exploratory research, in this area we observe that the very primary issues relating to measurement and reporting



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are not in their way towards settlement. Without doing this to state of agreement, how could the formulation of Accounting Standards progress with? We can notice the following areas where the research in this area needs to be promoted:

1. If the measurement and reporting on Intangible Assets could be of value relevance?
2. Are the methodologies followed in doing them call for any improvement?
3. Which precise hypothesis should form our basis of study to settle the issues involved, such as when and which of those Intangible Assets is appropriate to capitalize.
4. What can be the acceptable ranking of significance of various Intangible Assets for different industry from this point of view?

#### **Present Research: Voluntary Disclosure of Intangible Assets**

Along with the above stated aspect our study aims to come out with a thorough critical understanding of theoretical framework made available by the experts, researchers so far in this field and then to examine the Intangible Assets voluntary disclosure practices of the top 100 developing market companies by developing a Disclosure Index based on the Value Chain Scoreboard (Lev, 2001) to investigate the variety, nature and extent of Intangible Assets voluntary disclosure practices. Using Content Analysis as the main research tool, narrative sections of the emerging market companies' annual reports were examined to determine whether they utilize voluntary disclosure as an alternative reporting framework for disclosing Intangible Assets information to stakeholders. Apart from the above discussed areas our research was also supposed to cover the views of CEO's of

various industries about their perception for intangibles but due to unwillingness of the CEO's to cooperate, we decided at the tail end to rather study just the secondary data available about disclosures.

The term voluntary disclosure usually describes disclosures primarily outside the financial statements that are not explicitly required by GAAP or any accounting standards. Disclosure studies assume that, even in an efficient capital market, managers have superior information to outside investors on their firms' expected future performance. Companies who voluntarily disclose extensive business and financial information differentiate themselves by providing an enhanced level of information that helps investors and creditors understand the company better. Corporate information voluntarily disclosed helps investors to understand a company's strategy and its critical success factors as well as its competitive environment, the framework within which decisions are made, and the steps the company takes to ensure sustainable results. It is also argued that voluntary disclosure lowers agency costs, reduces the cost of capital, and improves the market price of securities. One reason for non-disclosure, however, is the cost associated with disclosures.

Although there seems to exist a broad agreement that the treatment of Intangible Assets in current accounting systems is not appropriate, there is a great controversy over the way in which this problem may be solved. Two alternatives which have been suggested in the literature are:

1. The inclusion of non-financial information and complementary statements as voluntary disclosures in the annual reports; and,
2. The modification of the accounting principles and the criteria for



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recognition of assets in order to reflect Intangible Assets in the balance sheet.

The majority of researchers and commentators feel that information about Intangible Assets is better conveyed outside the traditional financial statements. Relevant information could relate directly to the Intangible Assets or provide assistance in evaluating the extent to which they will generate future value. The information may be of different types – quantified

In summary, the sample companies were found to report a variety of Intangible Assets information, both quantitative and qualitative with varying degrees of extensiveness, in the narrative sections of their annual reports. Companies engaged in voluntary disclosure practices to explain their Intangible Assets, often using pictures and diagrams to support their disclosures, and contrary to the belief that most voluntary disclosures are qualitative only in nature, most Intangible Assets disclosures were supported by quantitative (financial and non-financial) information of Intangible Assets item being disclosed. One of the concerns regarding the study of corporate disclosure in markets is that there exists a possibility of bias towards non-disclosure; that is, too many companies simply may not disclose the information being examined, potentially rendering any subsequent analysis of data irrelevant. This is especially true for studies examining social and environmental disclosures of corporations, which are voluntary in nature, in developing markets. Further, as expected, 97.84% companies disclosed Intangible Assets information

Further, as expected, most companies disclosed Intangible Assets information stemming from the Discovery and Learning (86 companies) and Commercialization (84 companies) phases

of the Value Chain – 94.50 % and 92.30 % of the sample companies respectively, while only 62 out of 91 sample companies (68.13%) voluntarily disclosed information on Intangible Assets stemming from the Implementation phase

**Number of companies disclosing  
IA information**

Sample Companies	
IA Voluntary Disclosure in Annual Reports	Number of Companies (%)
Number of companies disclosing IA	91 (97.84%)
Phases of IA being disclosed	
Discovery and Learning	86 (94.50%)
Implementation	62 (68.13%)
Commercialization	84 (92.30%)

The economic status of the country of origin also seems to affect the nature of Intangible Assets activities being carried out which ultimately determines the type of Intangible Assets voluntary disclosure. Companies from countries with lower economic standing, however, adopted philanthropic activities such as providing scholarships and donations in the company name to enhance awareness of their brands in the community.

The type of Intangible Assets being disclosed by sample companies varied greatly according to their industry type. Not unexpectedly, companies disclosing most on “workforce training and development” and the impact of their activities on and subsequent preservation as part of “environmental reporting” were from the Energy/Materials/Industrials industry group which primarily comprises manufacturing, construction, and mining companies. In general, these companies included quite a large section on how to maintain their





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environmental policies above and beyond what is perhaps required of them via regulations in order to satisfy their obligations and legitimize their activities to the community.

Findings of the content analysis also suggest that while most companies engaged in Intangible Assets voluntary disclosure practices, did not necessarily disclose information on a variety of Intangible items. Contrary to the popular belief that most of the corporate voluntary disclosures are qualitative only in nature, however, it was found that the majority of companies disclosed Intangible information with quantitative (both financial and non-financial) components. Findings also indicate that the variety and nature of Intangible Assets voluntary disclosures varied based on each sample company's country of origin and industry type

With all above discussions beginning from definition to policy trends and disclosures of intangibles it becomes clear that we must now expand accounting, controlling-and management systems to a new level, to enable companies to optimize, manage and report on today's new value creating activities and processes because "What you can't measure you can't manage"

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