Accounting for intangibles : a tangible new responsibility

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Wealth and growth in today's economy are primarily driven not by the tangible but by the intangible assets. The importance of intangibles is widely acknowledged, but identifying, measuring and reporting intangibles have raised questions. The paper scans through the international practices set forth by IAS No. 38 and APB Opinion No. 17 as well as the lately issued FASB Summary of Statement No. 142. With regards to the national practices, the Institute of Chartered Accountants of India (ICAI) came out with the Accounting Standard 26 on "Intangible Assets" in 2002. The paper concludes by recommending that the difficulties in valuing intangibles should not discourage the companies from the disclosure of correct, factual and important information about the intangibles.

The value of a business increasingly lies not in the physical and the financial assets that are on the Balance Sheet, but in the intangible assets: brand, patents, franchises, software, research programmes, ideas, and expertise. Persistent competitive pressure induced by globalization of trade, deregulation and technological changes have forced the companies to rely on continuous innovations for survival and growth. Innovation in turn is primarily achieved by investment in intangible assets. It is therefore, hardly surprising that in recent times intangibles have become an important issue of discussion both in the academic and the corporate world. Central among the issues discussed are the shortcomings of the traditional accounting system in reflecting the value and performance of intangible assets. This calls for improved disclosure of information about intangibles.

What are the intangibles?

While the precise definition of intangibles might be elusive, it is generally defined as "an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes." So to be identified as an intangible asset, an asset should have the following characteristics:

- The concerned asset is a non-monetary asset.
- It should not have any physical substance.
- It has use in the operating activities or it is held for earning rent from others or it is held for administrative purposes.

Baruch Lev, the Philip Bardes Professor of Accounting and Finance at New York University defines an intangible asset as "an asset that promises future benefits and are not physical, like property, plant, equipment, stocks and bonds." He has grouped the definition of intangible assets into four categories. First, are associated with product innovation, such as those that come from a company's research and development efforts. Second, are assets that are associated with a company's brand. Third, are structural assets, such as processes, and systems of doing things. And, fourth are monopolies, the companies that enjoy a franchise, or have substantial sunk costs that a competitor would have to match or have a barrier to entry that it can use to its advantage.

Shahrokh M. Saudagaran defines intangible assets in a broad and a narrow sense. According to him in a broad sense, intangibles are non-physical sources of probable economic benefits to an entity that exist in addition to monetary and tangible assets. However, in a narrow sense, they are non-physical sources of probable future economic benefits to an entity that have been acquired in an exchange or developed internally from identifiable costs, having a finite life, market value and are owned or controlled by the entity. He classifies intangibles into three categories. First, are unidentifiable intangible assets that are typically included in goodwill since they cannot be separated from it. Second, are acquired identifiable assets such as patents, licenses, and trademarks. Third, are internally generated identifiable such as brands.

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On the basis of these definitions the three important criteria that should be evaluated to describe any non-monetary asset as intangible are:

1. Identifiability– An intangible can be clearly identified separately when an enterprise can rent, sell, exchange or distribute specific future economic benefit attributable to the asset without disposing of the economic benefit that is to be derived from other assets.
2. Control– An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and it can also restrict any one else to enjoy that benefit.
3. Future economic benefits– It includes revenue from sale of products or services and cost savings.

Importance of Intangible Assets

With the growth of global markets, the service sector and the level of mergers and acquisitions, intangible assets have become increasingly important. While assessing the total value of a comany it is not only the tangible but also the intangibles assets that should be considered.

Assessing Value
Total Value=Tangible+ Intangible

This is especially true since activities that create intangibles always lead to a set of tangible outcomes, over a period of time. For example, low employee satisfaction has an adverse impact on turnover, administrative costs, customer service, quality and process efficiency. For some companies, particularly those in new markets or in the service sector, where processes tend to be labor rather than capital intensive, the book values of their tangible net worth are often a small fraction of their market value. The data on market capitalization and book values of the Sensex Companies are presented in Table 1.

TABLE 1: Difference between Market Capitalization and Book Values of Sensex Companies

Name of the Companies	Market Capitalization (Rs. in crores)	Book Values (Rs. in crores)	Mkt. Cap– BV	Full Year Ended (Yr./Mth.)
1. ACC	25,662.00	10,196.37	15,465.63	2002/03
2. Bajaj Auto	49,274.66	28,654.18	20,620.48	2002/03
3. BHEL	39,161.60	44,693.18	5,531.58	2002/03
4. BSES	30,322.60	25,126.41	5,196.19	2001/03
5. Castrol Ind.	22,971.00	4,038.45	18,932.55	2001/12
6. CIPLA	62,248.86	9,163.42	53,085.44	2002/03
7. Colgate	17,950.68	2,393.42	15,557.26	2001/03
8. Dr. Reddy's Labs	35,658.32	2,800.63	32,857.69	2001/03
9. Glaxo Smith Phar	27,706.56	5,608.34	22,098.22	2001/12
10. Grasim Ind.	28,509.37	27,070.15	1,439.22	2002/03
11. Gujarat Amb. Cemmt	30,872.86	17,049.89	13,822.97	2002/06
12. HCL Technologies	12,877.76	3,472.40	9,405.36	2002/03
13. Hero Honda	12,141.76	1,369.94	10,771.82	2002/03
14. Hindalco	54,700.24	49,635.68	5,064.56	2002/03
15. Hindustan Lever	43,363.64	3,037.66	40,325.98	2001/12
16. HPCL	90,601.11	64,879.90	25,721.21	2001/03
17. ICICI Bank	30,630.04	58,549.65	27,919.61	2002/03
18. InfosysTech	119,752.71	10,400.19	109,352.52	2002/03
19. ITC	151,228.61	34,725.65	116,502.96	2001/03
20. Larsen & Toubro	43,016.45	39,609.95	3,406.50	2001/03
21. MTNL	83,790.00	95,256.00	11,466.00	2002/03
22. Nestle India	48,788.52	2,651.55	46,136.97	2001/12
23. Ranbaxy Labs.	92,720.00	16,017.38	76,702.62	2001/12
24. Reliance Industries	276,085.12	143,627.49	132,457.63	2002/03
25. Reliance Petro	119,643.93	106,118.96	13,524.97	2002/03
26. Satyam Computer	13,903.11	3,862.67	10,040.44	2002/03
27. SBI	115,786.00	134,627.54	18,841.54	2001/03
28. Tata Steel	41,233.92	47,492.64	6,258.72	2001/03
29. TELCO	41,581.80	36,687.94	4,893.86	2001/03
30. Zee Telefilms	4,950.00	4,092.00	858.00	2002/03

(Data Source: Capital Market, Vol. XVII/06 June 9,2002.)

With the exception of five companies all the companies have market capitalization above their book values. Even if the market values are taken to be inflated there is still a huge gap. Some could argue that this gap could represent market valuation failure; if that is the case, it is because of lack of relevant and reliable financial reporting system. The problem with traditional accounting system is that it completely ignores the value of intangible assets.

A proper disclosure of intangible assets would potentially yield greater transparency, enabling the investment and lending communities to make better decisions. The UK's company law review steering group's consultative document *Modern Company Law for a Competitive Economy: Developing the Framework* best sums up the importance of intangibles:

'... Current accounting and reporting fails to provide adequate transparency and forward looking information which is of vital importance in assessing performance and potential for shareholders, investors, creditors and others. We believe the time has come to require larger companies to provide an operating and financial review, which will cover the qualitative, or 'soft', or intangible, and forward looking information which the modern market and modern business decision making requires, converting the practice of the best run companies into a requirement for all.'

Accounting for Intangibles

The accounting for intangible assets must be considered in the context of the objectives of the financial statements as a whole. One of the objectives is to provide the users of the financial statements with useful and reliable information to facilitate their decision making process. To achieve this objective, the information must be relevant, understandable and reliable. It should also be consistent with the comparable information of similar enterprises. The identification and measurement uncertainties surrounding intangibles make it difficult to develop accounting information that meets all these attributes. For example, substantial resources could be invested in developing intangibles, but, due to the uncertainties of cost measurement, no asset is reflected in the balance sheet.

Accountants have made various proposals on how accounting for intangibles could more closely achieve the underlying objective of providing relevant and reliable information to users in a comparable and understandable manner. Some of those, which apply generally to all types of intangible, can be looked under the following headings:

Consistent treatment of all intangibles

Accounting for intangibles is subjective and complex by virtue of the fact that there are various ways by which they come about. Intangibles can be identifiable or unidentifiable, externally or internally generated and have determinate or indeterminate lives. Historically, there has been a divergence of practices used to account globally for intangibles. While this diversity mattered less in the past because these items were relatively small in value, standard-setters and users of financial statements are beginning to recognize the need to come up with comparable accounting methods for intangibles.

Disclosure

Improved disclosures of accounting policies and methods, expenditures on activities related to the generation of intangibles, and disposition of acquired intangibles provide the users with more information and allow them to assess better the comparability of financial statements of similar enterprises.

Historic Vs Current Cost

The difficulties in identifying the historic cost of intangibles, particularly those internally generated, have led some accountants to view the current cost model for intangibles as a possible solution to the problem of providing users with relevant information. One of the prosective accounting models proposed is Accounting for the Future (AFTF) in which the assets are defined in terms of Present Value of Expected Cash Flows (PVECF). Under AFTF it is not necessary to distinguish tangible from intangible assets.

International Accounting Practices

The International Accounting Standard (IAS) No. 38 "Intangible Assets"specifies the criteria under which an outlay can be treated as an intangible asset or must be written off as an expense in the income statement. The rule on the initial recognition and measurement of intangibles comes in two parts:

1. It is probable that any future economic benefits associated with the item will flow to or from the enterprise and
2. The item has a cost or value that can be measured with reliability. This rule precludes the recognition of internally generated intangibles as assets.

IAS No. 38 has included advertising, training, start-up, and research and development (R&D) activities as intangibles. It does not apply to financial assets, insurance contracts, mineral rights and the exploration for and extraction of minerals and similar non-regenerative resources. IAS No 38 permits two possible treatments for intangibles after they meet the initial recognition criteria. The preferred treatment is to carry the intangible asset at cost less any reduction due to amortization or impairment. The allowed alternative treatment is to revalue the intangible asset at its fair value less any subsequent amortization or impairment. Revaluation is only permitted if there is an active market from which to determine the fair value of the asset. IAS No. 38 presumes that the useful life of the intangible asset is 20 years or less.

The Financial Accounting Standards Board (FASB) Concepts Statements provide similar fundamental criteria for recognition and measurement of intangibles as IASC. The three criteria's are:

1. "It embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows,
2. A particular entity can obtain the benefit and control others' access to it, and
3. The transaction or other event giving rise to the entity's right to or control of the benefit has already occurred" (FASB Statement of Financial Accounting Concepts, No. 6)

Further, the asset also must be measurable and provide information that is relevant and reliable (FASB Statement of Financial Accounting Concepts, No.5). The Statement goes on to say that, to be reliable, the information must be "sufficiently free of error and bias to be useful" to the users.

The APB Opinion No.17 "Intangible Assets" calls for amortization of purchased identifiable intangibles over a period of 40 years. The costs of internally developed intangibles, which are not specifically identifiable or have intermediate lives, are generally deducted from income when incurred. The FASB issued Summary of Statement No. 142 "Goodwill and Other Intangible Assets" in June 2001 wherein it split intangible assets into two groups: amortizing and non-amortizing. Amortizing intangibles are those where in the owner can identify a finite useful life and such assets would be amortized over the finite life without the constraint of an arbitrary ceiling of 40 years. The non-amortizing intangibles have indefinite useful life extending beyond the foreseeable horizon. The statement calls for testing the non-amortized intangible assets for impairment at least annually by comparing the fair values of a reporting unit. The Statement further requires the disclosure or infonnation about intangibles in the years subsequent to their acquisition that was not previously required.

National Practices

The treatment of certain intangible assets had to be construed from the various accounting standards till the Institute of Chartered Accountants of India (ICAI) came out with the Accounting Standard 26 on "Intangible Assets" in 2002. The Accounting Standard (AS) comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for enterprises whose equity or debt securities are/will be listed on a recognized stock exchange in India and commercial, industrial and business reporting enterprises whose turnover for the accounting period exceeds Rs. 50 crores. In respect of all other enterprises the AS comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature. The AS is quite in line with the IAS No. 38 "Intangible Assets" issued by the IASC. According to the AS an intangible asset should be recognized and initially measured at cost if, and only if:

a. it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
b. the cost of the asset can be measured reliably.

The AS has included expenditure on advertising, start-up, research and development activities as intangibles. All internally generated intangibles are not recognized as assets because it does not meet the said recognition criteria. Further, it is also not applicable to:

a. Intangible assets that are covered by another Accounting Standards, i.e., AS 2 "Valuation of Inventories"; AS 7 "Accounting for Construction Contracts"; AS 19 "Leases"; AS 14 '"Accounting for Amalgamations"; AS 21 ""Consolidated Financial Statements"; AS 22 "Accounting for Taxes on Income";
b. Financial assets;
c. Mineral rights and expenditure

on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources; and

d. Intangible assets arising in insurance enterprises from contracts with policyholders.

According to the AS after initial recognition an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses. The depreciable amount of an intangible should be allocated on a systematic basis over the best estimate of its useful life but it should not exceed ten years from the date when the asset is available for use. A variety of amortization methods like straight-line, diminishing balance and units-of-production are suggested. The choice of the method for a particular enterprise should be based on the expected pattern of economic benefits and should be uniformly applied from period to period. The AS also calls in for a review of the amortization period and the method at least at each financial year-end.

Difficulties in Accounting for Intangibles

The valuation of intangibles is difficult due to the following reasons:

1. Companies have less control over intangibles, which causes higher risk.
2. 1f a company fails, its intangible assets cannot be sold off easily like the tangible assets.
3. There are no markets for intangibles, and a market is what provides a value.
4. Management has no incentive to share the information about intangibles. Not only they can be held liable for errors, but also sharing the information would further complicate investor relations.
5. Intangible assets essentially represent the secret of a business enterprise. If the company shares those secrets with the investors (and with the competitors), it could hasten the erosion of those very intangibles.

In words of *Bob Williams*, an accounting expert at Lehman Brothers, " Accounting for intangibles introduces so much more uncertainty and judgment into the accounting process and for a profession that likes its assets hard and well defined that is a problem."

Conclusion

Keeping in mind the gap between the information provided in today's financial statements and the information need of the investors, creditors and others the ICAI has aptly come out with the AS on intangible assets. An important question which now posed is: How well will the companies be able to measure its key intangible assets? Keeping in mind higher level of uncertainty and risk involved any inconsistent measuring could distort the conclusions. The challenge of measuring intangibles correctly has put yet another tangible responsibility on the shoulders of the Indian companies.

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