The Intangible Assets Investments: Accounting Treatment and Risks for Capital Investors and Management

Violeta SĂCUI[1]
Diana Claudia SALA

Abstract

In the knowledge-based economy, the fundamental determinants of the company's value, in the present, have an intangible nature. The intangible investments are the most important factors of the enterprise success. Wealth, growth and welfare are driven nowadays by intangible investments. The knowledge economy is characterized by huge investments in human capital and informational technology.

The current accounting regulation does not allow companies to capitalize a big part of investments in intangibles (produced by a company) and to report these as assets in the financial reports. There are inconsistencies regarding the book-keeping treatment of the two categories of intangible assets: internally generated and externally, acquired from the outside of the company.

Keywords: *investments, intangible assets, valuation, book value, investors, managers.*

JEL classification: M21, M41, G31

Introduction

Generally, the intangible assets independently acquired from the outside of the company, are capitalized at the cost implied by their acquisition. On the other part, the costs associated with developing internally generated intangible assets are treated as expenditures and are reflected in the revenues and expenses situation.

The intangible assets that are acquired from the outside of the companies are recognized as assets and are reported in the balance-sheet with the further information disclosed in the footnotes. Among these we mention: brands, trademarks, franchises, patents, copy rights etc.

Other elements of intangible nature such as advertising and promotion expenses, marketing research expenses, restructuring costs, organization costs, training costs, corporate culture, customer loyalty, employee satisfaction, etc., are not normally included separately in the balance sheet, appearing only aggregately

[1] **Violeta SĂCUI**, The Western University of Timisoara, Romania
E-mail: violeta.sacui@feaa.uvt.ro
Diana Claudia SALA, The Western University of Timisoara, Romania
E-mail: diana.sala@feaa.uvt.ro

under goodwill after the acquisition of a company (acquired goodwill). Thus, in the case in which the companies, successfully, allocate resources to such activities their balance-sheets will not reflect so called internally generated goodwill.

1. The accounting treatment of intangible assets investments. Lack of reliability versus lack of relevance of financial information

When it comes to the recording of internally generated intangibles, very little has changed during the last decades, regarding intangible assets. Traditionally, the sums allocated to the internally generated intangible assets are treated as expenses not like investments that are capable to generate long term economic benefits.

As a consequence, there are a big variety of intangible investments that can be considered as assets from an economic point of view but cannot be recognized in the balance sheet from the financial accounting standards point of view in many countries.

The existed situation is explained by the fact that it is considered that the economic properties of intangible assets investments are not in concordance with conventional accounting principles (Meritum2002). The International Accounting Standards (IAS 38) consider as necessary criteria for reporting intangibles the property and control over future benefits.

Hendriksen (1982) highlighted that the high uncertainty associated to the expected future benefits of some kinds of intangible assets investments hinders the recognizing of these as assets in the balance sheet in situation in which the one of the imposed recognizing conditions is the control over the asset. Thus he suggests that the utilized criteria for the tangible assets recognizing and valuation may not be applicable to intangibles.

As Wyatt and Abernethy (2004) highlighted”the high uncertainty associated to the intangible assets investments make these to be, systematically, excluded, in any explicit form, from enterprises management and financial reporting”.

This uncertainty creates an obvious problem for the accountancy that has the responsibility of reporting the accountant numbers that are utilized by the investors, lenders and, managers, in investments and lending decisions, in decisions related to the allocating of resources inside of the companies.

The purpose of the elaboration of the accountant and financial reporting standards elaborations is to protect the financial information users for rational investment decisions taking, rational credit decision taking, and other kind of decisions. Traditionally the main users of the accounting information have been considered the investors and lenders.

But because these cannot have a direct control on the process of accountant situations preparation, it have been elaborated the financial accountant standards, intended to ensure that investors and lender will be the users, in a proper time, of a reliable, credible and relevant information, that permit efficient decisions taking (Meritum,1999).

The investors and lenders need the accurate, transparent and credible financial information that can be compared along the industries and companies to facilitate the capital market participation. The mission of the International Accounting Standards is to protect the consumers of financial information, like investors, lendors and managers.

From the accountancy point of view, it must be realized a selection between the two accountant treatments, namely:

- the excluding of intangible assets from the balance sheet for the reason that these represent the uncertain elements, on one side;
- the including of intangible assets in balance sheet because, as has been demonstrated, these represent an important source of value creation at the level of enterprise, on other side.

It is considered that, although the valuation and inclusion in the balance sheet of this important group of intangible assets implies risks, the lack of valuation and exclusion of these from the balance sheet determine the loose of relevance of financial situations**.**

Reliability is an essential characteristic for accounting information to be useful for decision making. Reliability represents the extent to which the information is unbiased, free from errors and representational faithful (IAS, 1996).

Including in the balance sheet of the uncertain investments imply risks for the investors, lenders, managers and other persons that utilize the financial information in multiple purposes.
This generate the risk of appearance the errors in company valuation, in measuring the current performance and, in forecasting the future performance of the company.

In the present, the intangible assets investments are the most important determinants of the enterprise value. The level and the importance of this type of investments increased very much during the time. In these conditions, the amount of intangible investments that are not reflected in the company's balance sheet is very high.

In consequence, the financial situations users have an incomplete picture regarding the intangibles owned or controlled by the companies. They only observe the intangible assets that satisfy the criteria imposed by the accountant standards for recognizing of the elements as assets in the balance-sheet (Meritum2002).

In the present, the existence of intangibles is reflected at the company level only, indirectly, through the economic performance raising**.** As Mortensen, Eustace and Lannoo (1997) mentioned, **"**currently most intangibles are only revealed indirectly by incremental economic performance that is not accounted for by available data on employment and tangible investment"

The consequence of the current accountant treatment applied to intangible assets investments is the loosing of relevance of the accountant information**.**

2. The reasons of lack of relevance of financial information

The absence of an important part of intangible assets from the company's balance sheet and the accountant treatment of these has a negative impact on the value of information offered by these.

There are significant deficiencies regarding the information received by the stockholders, lenders, manager and the other stakeholders.

The information from current company's financial situations doesn't truly reflect the current financial position of these companies and their future prospects.

As a result, the ability of financial statements to provide an accurate view of the company's financial position seems to have decreased over the last few decades, along with the increase in the importance of intangibles (Meritum 2002).

The principal reasons that justify the lack of the relevance of the accountant financial information can be mentioned as following:

- The lack of reflection of one of the most important sources of value creation at the company's level.

The excluding of an important part of intangible assets investments from the balance sheet implies the ignorance of an important source of value creation at the company's level.

Today, intangible assets like human capital, brand, organisational capabilities, information technology, are significant determinants of the value. t is obvious that, in a competitive market environment, the value creation driver is intellectual capital, rather than financial and physical capital**.**

As some researchers point out (Daum, 2001; Steenkamp, 2007) the value determinants, in this case, refer to all factors which amplify the value of products and services, as it is perceived by consumers, and, therefore, to all factors which determine the company's income, growth, wealth and the success.

Hunter (2005) emphasized fact that goal of all commercial activities is to add value to elements or resources used in the course of the business. The organisational success in value creation process reflects its competitive advantage and the ability to survive and overtake the competitors.

In the present, the current financial situations of companies do not allow to evidence the performance ant its value potential generation.

- The negative impact on the book value and current earnings

In situation in which the intangibles are fully expensed as they are undertaken and are not reflected in the balance sheet, both earnings and book value of equity will be under evaluated.

As Lev&Zarowin(1998) have outlined, the effect of registering as expenses of research development and restructuring investments is the decreasing of reported earnings and book values despite of the fact that company's cash-flows and market value is, generally, increased by such activities.

In such situation, the investors receive erroneous information regarding the current value of enterprise and it's capabilities to create value in the future.

- Distortion of the correlation revenues with costs principle

The immediate expensing of intangible assets investments and registering the revenues generated of these assets in the future periods has a consequence, as the distortion of the correlation revenues with costs principle.

- The negative impact on the performance measures

The absence from the balance sheet of the financial information regarding the intangible assets value has a negative impact on the performance rates calculated upon it. The levels of rate of return measures like the rate of return on investment and the rate of return on equity are influenced by the accountant treatment applied to intangible assets investments.

Wyatt (2005) has demonstrated the ways in which the rate of return on assets can be influenced by the accountant treatment applied to intangible expenditures (capitalization or immediate expensing).

Meritum (2002) highlighted that „the failure in correct reflection of an intangible assets investments impact on actual and future company's performance implies that the current accounting systems failing to offer a trully and correct point of view regarding the enterprise financial position". As a consequence, the accounting information as it is presented in the balance sheet is loosing its relevance.

3. The concequences of loosing the financial situations relevance

The consequences of loosing the relevance of accounting information are numerous. In this section we mention some of these:

- The growing divergence between the market value and the book value of equity

The accountant treatment of intangible assets investments determined the raising of the discrepancy between the market value and the book value of equity.

A sign of the loss of accounting information relevance is the increasing gap between the market value and the book value of equity of the most companies in many countries (Lev&Zarowin, 1998**).**

Lev&Zarowin (1998) documented a significant increase in the market-to-book value ratio of US companies, from a level of 0.81 in 1973 to a level of 1.69 in 1992 (which means nearly 40% of the market value of companies is not reflected in the balance sheet).

Lev (2001) revealed that the intangible assets value rose, constantly, from an average of 40% in total market value of companies at the end of '80 years, to 80% from companies' total value at the end of the 20 century.

The study regarding the USA listed companies highlighted the important gap between the book value and market value of companies (Cuganesan, 2006).

In the present, the intangible assets as customers and business partners' relationships, the human resources, the patents and trade-marks, organizational capital in the form of superior business processes, organization structures and a unique corporate culture, have the biggest weight in the enterprise market value.

In the conditions of the current accountant system, a typical investor does not receive an accurate picture about the true value of the company. The current accountant treatment applied to a large part of intangible assets investments determined the loosing of financial accountable information relevance about the company value.

A lot of researchers **(**Collins, 1997; Francis&Schipper, 1999; Hung, 2001**)** have outlined that, generally, the financial information value relevance is related of the financial situations ability to synthesize the information that affect the company's value.

According to Barth (2001) and Olsson (1995) an accounting indicator is considered relevant as regards the value if it is significantly associated with capital market indicators like the stocks prices and rate of return.

As it was emphasized by the European Commission in its report Towards a European Research Arena, "the European financial market has not yet sufficiently discovered the economic value of investment in knowledge" (European Commission, 2000b).

This situation is explained by the fact that the information concerning the value provided by companies to the financial markets is primarily based on traditional tangible investments in fixed assets, whereas value is more and more relying on investments in intangible assets.

The analysis of the listed USA companies revealed that in the case of the knowledge-based companies, the intangible assets investments have a weight comprised between 15% and 25% in the their market value (Ballow, 2004).

The research realized during the last time revealed that intangible assets investments have an important impact on the companies profits and cash-flows and, implicitly, on their market value.

For having a positive impact on the company's market value, the intangible assets investments must be perceived as investments with positive net present value, not only by the company`s management but by the majority of market investors.

The realized research pointed that the market, generally, doesn't question the wisdom of companies' intangible assets investments and, that this kind of investments are perceived as assets of the organizations.

- The capital cost increasing

It must be noted that immediate expensing of intangible assets investments deprives investors of valuable information regarding the company's activity. They must make more efforts and support more costs to obtain these. This situation is probable to determine the cost of capital increasing at the company`s level.

The higher information asymmetry between management and shareholders and among shareholders lead to inefficiencies in capital markets and higher capital costs.

On the other hand, the lack of knowledge on the company's intangibles will be a source of uncertainty over its future earnings that could translate into an excessive volatility of stock prices. This will lead investors to attach high levels of risk to the companies (a higher cost of capital), thus making it harder for the company to obtain funding for innovative projects and, therefore, lowering its future earnings (Meritum, 2002).

- Distorsions in resources allocation decisions

Also, there is a high risk associated to lack of reflection of intangibles in the financial situations. It has been documented that the informational deficiencies caused by current accounting treatment of intangible assets investment can be a source of important looses for persons that take decisions on the on financial information reported, periodically, by companies. This is a consequence of the fact that can appear distortions in resource allocation decisions.

In this conditions, the investment and lending decisions and, also, managerial decisions, that are based on these situations (which doesn't reflect intangible determinants of companies values) could cause significant looses, both at the company level and, to their products, services and capital suppliers (Meritum, 2002).

In this conditions in which the investors and lenders receive the irrelevant and incomparable financial situations, they will not be able to assign the companies value for ensuring the taking of efficient resources allocation decisions.

As I mentioned earlier, in situations in which the companies make important investments in intangible assets, the earning, book value, the performance rates, will be negatively influenced.

This situation has a negative impact on the valuations realized for purpose of capital market investments, lending decisions, mergers acquisitions, allocating resources inside of the enterprise.

Because the financial analysts do not have enough information about intangible determinants of the company's value, their estimates regarding the earnings and the growth rates could be very optimistic or very pessimistic.

Because these estimations are used by the investors as a base for their investment strategy formulation, this fact may have some negative consequences for them, like the followings:

- the first case (very optimistic estimations) may lead to companies overvaluation; this thing may cause looses for investors in the case of stock value decreasing as response of new information reception that have not been reported earlier by the managers;
- the second case (very pessimistic estimations) may lead to companies' subvaluation, fact that may facilitate hostile takeovers and decreasing the enterprise capability to access resources.

The registration as expenses of the intangible assets investments, at the moment of their realization, may cause the company subvaluation.

The failure in the identification and determination of a considerable part of intangible assets and the absence from the balance sheet of information concernig intangible actives may, probably, cause companies subvaluation (Meritum, 1999).

Barth, Kasznick și McNichols (1998) argued that more and more is the weight of investments in intangible capital, so much more is the probability of enterprise subvaluation.

In conditions of lack of reflection of intangible assets in the company`s balance sheet and registration of these as expenses, may appear some deficiencies in the resource allocating process in capital markets.

As a consequence of utilising the information from public financial situations, the investors may take the resources allocation decisions being interested by especially companies with low intangible investments or without such investments.

The reason for this is reporting, by these, of a high accounting numbers regarding earnings and book value on the short time (with the high probability of performance decreasing in the future).

Despite of the fact that the companies that make important investments in intangibles seems less attractive on the short time, these can obtain much higher performances on long time.

Conclusions

The international accountancy standards have not taken steps to allow for the capitalization of most internally generated intangibles. There are inconsistencies regarding the book-keeping treatment of the two categories of intangible assets: internally generated and, externally, acquired from the outside of the company. Generally, the intangible assets independently acquired from the outside of the company, are capitalized at the cost implied by their acquisition. On the other part, the costs associated with developing internally generated intangible assets are treated as expenditures and are reflected in the revenues and expenses situation.

In the present, the intangible assets investments are the most important determinants of the enterprise value. The level and the importance of this type of investments increased very much during the time. In these conditions, the amount of intangible investments that are not reflected in the company's balance sheet is very high.

In consequence, the financial situations users have an incomplete picture regarding the intangibles owned or controlled by the companies. From the accountancy point of view, it must be realized a selection between the two accountant treatments, namely: the excluding of intangible assets from the balance sheet, for the reason that these represent the uncertain elements, on one side, and the including of intangible assets in balance sheet because, as has been demonstrated, these represent an important source of value creation at the level of enterprise, on other side.

It is considered that, although the valuation and inclusion in the balance sheet of this important group of intangible assets implies risks, the lack of valuation and exclusion of these from the balance sheet determine the loose of relevance of financial situations.

The absence of an important part of intangible assets from the company's balance sheet and the accountant treatment of these has a negative impact on the value of information offered by these.

There are significant deficiencies regarding the information received by the stockholders, lenders, manager and the other stakeholders. The information from current company's financial situations doesn't truly reflect the current financial position of these companies and their future prospects.

The consequences of loosing the relevance of accounting information are numerous: the growing divergence between the market value and the book value of equity, the capital cost raising, distorsions in resources allocation decisions.

References

1. Anson, W., (2003), *Valuing IP Assets in Bankruptcy*. IPL Newsletter, Vol. 21, No. 2.
2. Ballow, J., Burgman, R., Roos, G., and Molnar. M., (2004), *A New Paradigm for Managing Shareholder Value,* Accenture Institute for High Performance Business.
3. Barth, M., Kasznik, R. and McNichols, M.,(2001), "Analyst coverage and intangible assets", *Journal of Accounting Research*, Vol.39, No.1, pp.1-34.
4. Belkaoui, A.R. (1992), *Accounting Theory*. London: Academic Press.
5. Collins, D. E. Maydew and I. Weiss (1997), "Changes in the value relevance of earnings and book values over the past forty years". *Journal of Accounting and Economics*, forthcoming.

6 Corcoles Yolanda Ramírez, (2010), *Towards the convergence of accounting treatment for intangible assets,* Intangible Capital Working Paper.

7. Cuganesan, S. (2006), "Reporting organisational performance in managing human resource. Intellectual capital or stakeholder perspectives?", *Journal of Human Resource Costing and Accounting*, Vol. 10No. 3, pp. 164-188.
8. Cuganesan, S., Petty, R,. and Finch, N., (2006), *Intellectual Capital Reporting: A User Perspective Academy of Accounting and Financial Studies*, Spring International Conference, New Orleans, USA.
9. Daum, J.H. & Norton D., "Intangible Assets und die Balanced Scorecard – Interview mit David Norton", in: *Controlling & Finance*, 6 / 2001 June.
10. Francis, J. and Schipper, K. (1999), "Have Financial Statements Lost Their Relevance?" *Journal of Accounting Research*, 37(2), pp. 319-352.
11. Fisher I., (1930), *The Theory of Interest*, NY: Macmillan.
12. European Commission (2000a) *Innovation policy in a knowledge-based economy. Final Report of the expert group. A MERIT study Commissioned by the European Commission.* Enterprise Directorate General.
13. García-García, *J. & M.I. Alonso de Magdaleno, (2010), Fair value on Open Source business*. XIV Encuentro AECA, Coimbra (Portugal).
14. Hendriksen, E.S. (1982), *Accounting Theory*, 4th ed. Burr Ridge: Irwin.

15. Hunter L., C., Elizabeth Webster and Anne Wyatt, (2005), *Measuring Intangible Investment*, Melbourne Institute Working Paper Series Working Paper No. 15.
16. Hung, M. (2001), "Accounting Standards and Value Relevance of Financial Statements: An International Analysis", *Journal of Accounting and Economics*, 30(3).
17. International Accounting Standards Committee (1996), *Framework for the Preparation and Presentation of Financial Statements,* International Accounting Standards 1996, London, IASC.
18. International Accounting Standards Boards (IASB) (1989), *Framework for the Preparation and Presentation of Financial Statements*. London: IASC.
19. International Accounting Standards Boards (IASB), (2004a), *Intangible Assets. International Accounting Standard,* IAS, n°. 38 revised. London.
20. International Accounting Standards Boards (IASB) (2004b), *Impairment of assets. International Accounting Standard,* IAS, n° 36 revised. London, IASB.
21. Jarboe, K., P., Furrow R.,(2008) *Intangible Asset Monetization, The Promise and the Reality, Information Innovation Intangible Economy,* working paper.
22. Lev, B. (2001), *Intangibles: Management, Measurement, and Reporting*, Brookings Institution Press.
23. Lev, B. and P. Zarowin (1998), *The boundaries of financial reporting and how to extend them.* Working paper. New York University.
24. Lev. B. & Sougiannis, T. 1999. "Penetrating the Book-to-Market Black Box: The R&D Effect". *Journal of Business Finance and Accounting*.
25. MERITUM, (1999), *The Value Relevance and Managerial Implications of Intangibles: A Literature Review*, Fundación Airtel Móvil, Madrid.
26. MERITUM (2002), *Guidelines For Managing And Reporting Intangibles, (Intellectual Capital Report),* Fundación Airtel Móvil, Madrid.
27. Mortensen, J., C. Eustace and K. Lannoo (1997), *Intangibles in the European economy*. Paper presented at the CEPS workshop on intangibles in the European economy. Brussels.
28. Napier, C. and M. Power (1992), "Professional research, lobbying and intangibles: A review essay*". Accounting and Business Research*, Vol. 23, No. 89.
29. Ohlson, J.A., (1995), "Earnings, Book Values and Dividend in Equity Valuation", *Contemporary Accounting Research*, 11, 661-668.
30. Steenkamp, N. (2007), *Intellectual Capital Reporting in New Zealand: Refining Content Analysis as a Research Method*, Auckland University of Technology.
31. Wyatt, A., and M. A. Abernethy, (2004), *Accounting for Intangible Assets: A Conceptual Framework for Measurment and Reporting on Intangible Assets*, working paper, University of Malbourne.
32. Wyatt, A., (2005), "Accounting Recognition of Intangible Assets: Theory and Evidence on Economic Determinants". *The Accounting Review 80*, 967-1003.