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Emerging Markets Queries in Finance and Business

The Intangible Assets – A New Dimension in The Company's Success

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Abstract

This paper is based on the assumption that there is a strong influence between the intangible assets on the financial value and the performance of a business. This is more obvious especially in the case of the businesses which require a considerable creativity or are science-based. Among others, we can mention the significant difference between the market value and the net book value of the intangible assets. In the best case scenario, the intangibles like the human skills or the customers' value are usually improperly recognized or accounted for. We talk about further implication when the auditors certify that the balance sheet shows the fair view of the financial position of business in spite of the fact that it is not showing all the values involved. There have been only few researches in this field have and there is no model available, which could be considered to be free from major limitations. The major limitation of the existing models is that there is a clear difficulty to correctly identify all types of intangible assets and their influence inside a business. These are the facts that underlie our decision to start a research in this domain. Our study aims to propose a realistic practice for the valuation and accounting of intangibles the know-how or the customers' value, starting from the analysis of the previous efforts done in this field by other researchers.

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1. Introduction

Even to the casual observers of Knowledge Management KM trends the links that exist between KM and the equally active field of Intellectual Capital IC are fairly obvious. We start by addressing the fact that professionals are yet to develop the appropriate means to measure and report intellectual capital in terms of intangibles that can add considerable value to business organizations in the knowledge economy experienced today. Like KM itself, the related field of IC is in a state of early development in which competing theories abound on what intellectual capital is, how to measure it and how to report it, divisions among them being enormous.

It should be useful to point out that the problems and questions posed by IC theoreticians and practitioners are almost always framed in terms of accounting. In other words, the IC problem is universally seen as an accounting problem, a narrow problem of computing a certain type of intangible value.

Beginning approximately in 1980, something strange started to happen in the New York Stock Exchange: the value of stocks started to exceed the book values of its member companies by unprecedented margins. By 1990, the value of the Dow Jones Industrial Average was actually double the book values of its 30 constituent companies; by late 1990s, the intangibles-to-book ration had risen to 3:1 – all this despite the fact that the sources of these values were utterly unaccounted for on the balance sheet. This made - and still makes – the IC problem.

As a result of the way in which the IC problem was articulated the quest for solutions was launched by accountants, for accountants and within accounting. Nevertheless, the manner in which the problem had been described, as well as the identification of the situational context that lies behind the problem might have been biased. Furthermore, history proved that rejection of old knowledge and the science behind it accompanies intractability, and are consequently followed by the arrival of new knowledge. The lessen the capacity of old knowledge to resolve new issues raised by continuously changing contexts, especially in economic terms, is a historically critical sign that old knowledge is to be considered obsolete. In his well-known book on scientific revolutions, Thomas Kuhn 1970, 5 describes this phenomenon in the following way: “Sometimes a normal problem, one that ought to be solvable by known rules and procedures, resists the reiterated onslaught of the ablest members of the groups within whose competence falls.” This would seem to be fairly an accurate description of what’s going on in the accounting world today. We have the economic value of companies as reflected in their market capitalizations exceeding the capacity of our ‘normal’ accounting systems to account for them. In response, we have the ‘ablest members’ of the accounting profession working feverishly to solve the expressed problem: how to render intellectual capital – or “intangibles”, in its broader form – measurable? The purpose of this question would be to squeeze it into the balance sheet where they think it belongs, and thereby make the measurement system comport with what the marketplace is doing.

Still, we believe that this approach is misguided for several reasons. First of all is the bias of the claims embedded in the manner in which the problem is framed as well as the assumptions about what a satisfactory solution would look like in this context. We believe that the a successful solution would actually not be consistent with the knowledge there is already at hand; rather we believe that there is room for the assimilation of a new theory that involves the “reconstruction of prior theory and the re-evaluation of prior fact, an intrinsically revolutionary process that is seldom completed by a single man and never overnight”, as Kuhn puts it 1970, 5.

The objections we propose to the current manner in which solution are being sought to the IC problem are fourfold. First, there is no recognition of the economic value of social capital, in any meaningful or complete sense. Secondly, the solutions being sought mistakenly assume linear relationships among components of the IC scheme. Third, there is an undue accounting-centric orientation to the formulation of the problem. An last, but not least, IC schemes fairly fail to see the market in which corporate valuations are made as a separate system that lies outside the enterprise.

2. Considerations on social innovation capital

Much has been said and written about the intellectual capital since Tom Stewart first started writing about it in *Fortunes* magazine Stewart 1994. Since then, KM has been firmly linked to intellectual capital in various ways, prominently being the approach to knowledge - personal and organizational – as worthy of the term ‘capital’. What is still incompletely dealt with, is that the financial value of a corporation usually exceed the book value of its tangible assets, and so intangible must as well have financial value. In earlier examinations carried out by scholars McElroy 2002 IC is all about reflecting the value of intangibles in the attempt to compute their impact on corporate valuations; it follow that the capacity to produce and integrate knowledge itself should find a way in related schemes. Moreover, it supposes that the only thing potentially more valuable to a firm than its prized intellectual capital should be its institutional and ongoing capacity to produce it. While outdated, the Skandia model is still emblematic to the IC community’s broader failure to take social capital fully into account. While we see the evidence of this omission in the early Skandia model and in many others since then, we have yet to see any truly rigorous attempts to incorporate social capital in the taxonomies of IC being debated in leading academic circles. This in itself becomes an issue as the knowledge life cycle is nothing but a form of social capital. It is social in the sense that it is a particular kind of process carried out by the people in social settings, and it is capital in the sense that its performance can add value financial and otherwise to the lives of people involved and the enterprises f which they are part of. Clearly, the quality and performance of knowledge processing has financial valuation implications in a company. Therefore, this particular kind of intangible asset is a social capital of an innovation sort. The capacity to innovate – sustainably and with regularity and reliability – should be treated as deserving of value itself. Thus, no comprehensive attempt to reflect the categorization of IC should be seen as complete until and unless it includes both social capital, broadly, and social innovation capital, in particular, as the only thing more valuable than valuable organizational knowledge may be the organizational capacity to produce it.

While most IC valuation and reporting schemes tend to focus only on object or outcomes in their approach to measurement, processes can add value as well. Further, the capacity to continuously learn and innovate on a high-performance basis is, itself, more valuable to a firm than any IC outcomes it might produce, such as patents or technologies. The value of most innovations is ephemeral and so learning must be a continuous source of new knowledge and innovation responding to the epistemic problems that almost always rise from existing knowledge. In this case we should consider adding social capital in its various forms to either side of the balance sheet. A firm’s capacity to innovate could be so poorly configured that it actually detracts from the value of a firm by dampening its capacity to learn and therefore adapt. A firm’s social innovation capital could be in some cases not seen as an asset at all, but as a liability. Clearly, the knowledge life cycle is a major source of competitive advantage in a company, assuming it’s strong and responsive. In such cases it should be counted for as an asset.

3. Biased linearity

Among the first principles of the new KM is the view of organizations as complex adaptive systems. Outcomes are the nonlinear, emergent results of countless interactions between agents, who each have their own rule sets, are autonomous and who at time collectively work together toward achieving common goals, but at other time work either independently or against one another and still achieve their goals. In complex adaptive systems adding 1 to 1 is more likely to add to 3, 4 7 or even 10, rather than 2. This is the anathema to conventional accounting. Balance sheets and income statements are the products of linear, or at least reductive, thinking. There is no place in them for taking account of emerging processes. Value outcomes may be describes and explained in retrospect, as they are not predictable in practice. In this case, value is not reducible to its simple components.

The inability to predict nonlinear, dynamical outcomes has another practical implication on related accounting theories and approaches: there are no certain formulas or principles available on how best to create intellectual capital. Organizations can't control the production of IC in any simple cause-and-effect sense at all, so how can accountants purport to do so in ways that are as predictable and standardized as, say, the manner in which they manage fixed assets and reflect their values on a balance sheet? If, for example, an employee generated solution to organizational processes lowers the costs and raises the revenues, the income statement reflects these effects and an eventual patent shows up on the balance sheet. Meanwhile the market notices these changes and the company's stock prices increases such as the market value becomes triple its book value. What happened is that the market recognized and rewards the organization's capacity to innovate and adapt – not just in terms of outcomes themselves, but the newly demonstrated institutional capacity to learn. In other words, the market is placing premium on the company's social innovation capital and the higher price of the stock reflects it. Still there is the issue of measuring social innovation capital in conventional terms causing a need to shift focus from the outcomes to the causal influences that produce them. Hence the focus should be more on the social processes and their quality than on the quality and impact of their outcomes.

Even though such a successful scenario is desirable management should not necessarily conclude that all organizational scenarios need to be tackled from employee perspective or that the processes followed to solve the previous situation of the firm should be codified into a patterns and replicated throughout the firms. As the outcome experienced was itself an emergent outcome unaccounted for by either linear or nonlinear models.

In the light of the above, we believe a credible case can be made for simply reflecting the cumulative effects of organizational activity on a company's intangible market value in one line item of the balance sheet: organizational and market intangibles. This would simply be the difference between market capitalization and book value. Anything that cannot be accounted for in tangible book value form would be lumped into this new category.

By reflecting the value of intangibles in a single category, the emergent outcomes of both internal organizational dynamics of a firm and the separate external influences of the marketplace could be reflected in what is otherwise a linear tool for measuring and reporting. And since unlike the rest of the balance sheet's contents, emergent assets and liabilities are not subject to prediction or to reductionist constructions, we could relieve the accounting profession's frustration with its inability to do so and relegate the whole problems to the realms of new theory and practice. We, of course, believe that the key to growth and sustainability in the value of organizational and market intangibles lies most in the efforts to manage the strength and composition of social innovation capital. That is where investments should be made in growing the value of a firm and recognizing the nonlinear trajectory of related outcomes is crucial to their accounting.

Our last criticism of the approaches taken this far in the quest to solve the IC problem is that they fail to recognize the fact that in looking at corporate valuations, we are dealing with two social systems, not one. The first is enterprise and the second is the securities market, in which its shares are traded. Managers and employees inhabit the first system; shareholders, the press, regulators and financial analysts inhabit the second one. When we take up the question of conventional financial reporting, we are by definition speaking of value found within the former and controlled by its inhabitants, especially its managers. When we speak of intangible values, however, it is important to recognize that they are produced by the latter and controlled by their consequent inhabitant, especially its stockholders, and then conferred by them onto the former. Therefore, to try and reflect the value of intangibles using conventional reporting tools is to undermine the spirit and intent behind them because their purpose in capital markets is to report on things that managers can control, and not on things that they merely inherit as if they were controlled. But here again, we are operating at the point of development of the discipline, where everything is merely theoretical. Standardised balance sheets and income statements need more than that. The organizational and market intangibles are not at all controlled in the same sense that the value of tangible, book values are, nor are they even formulated from within the same system – the enterprise.

4. Conclusions

Underlying all of our comments regarding the unsuitability of conventional accounting perspectives in the treatment of intangible values are four key points:

- The most important source of intangible economic value in a firm is external to itself – not found at all within the firm, and therefore not directly manageable by it. The origin of such value is in the minds of current and prospective stockholders, whose valuation of a firm is determined within the dynamics of their system, not the enterprise's. Their values are then projected onto the enterprise, which in turn receives it as a kind of inheritance, always subject to adjustment and even return.
- Apart from being determined by agents outside of the enterprise, reflecting the value of intangibles using conventional accounting tools as though they were internally managed suffers from another problem. Balance sheets are static models, they are predicated on the assumption that it is possible to start with a market value that can then be broken down into its additive elements. Knowledge and the processes that produce and integrate it, however, are anything but additive. What we need is a dynamic model to account for such items.
- While it is true that processes and outcomes in complex adaptive systems are emergent beyond the absolute control of managers, it is possible to have impact on the, nevertheless – even intended impacts that give rise to corresponding outcomes. Rather, management in such environment must begin with recognition of organizations as social complex adaptive systems, subject to unpredictable effects. In this way, managers produce decisions and value judgments assigned by markets to the enterprise which further influences and makes manageable the market value of the company.

We are only prepared to support the reflection of intangible values in the lump sum fashion we have proposed. What's required instead is a period of trial and error or experimentation, in which competing theories of how intangible values are produced can be tested and evaluated. On the basis of these closing remarks, we believe that the accounting profession should undertake a focused effort to test and evaluate the use of nonlinear models in accounting.

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