THE ACCOUNTING OF INTANGIBLE CAPITAL

CRISTINA-IONELA FĂDUR, DANIELA CIOTINĂ
"ALEXANDRU IOAN CUZA" UNIVERSITY, THE FACULTY OF ECONOMICS AND BUSINESS ADMINISTRATION, IASI
11 CAROL I BLVD. IASI, ROMANIA. 700506
cristina.fadur@yahoo.com, ciotina_daniela@yahoo.com

Abstract:
In the new economy – the knowledge economy – the traditional role of financial statements to reflect a faithful image of the company is questioned. Since the evaluation of intangible assets is subjective, annual financial reports do not include information concerning the intangible part of the business. More than ever, information and communication contribute to the image of the company as an essential element in evaluating its situation in the market competition. In the context of the current economic crisis, transplanted on a knowledge economy, managers must focus on the efficient usage of intellectual capital, classified into human capital, structural capital, and relational capital.

Key words: *intangible capital, financial reporting, IFRS 3, knowledge economy*

JEL classification: *M49*

"The empires of the future are empires of the mind" (Winston Churchill)

The New Economy

The reception of knowledge and information as resources of development makes us more familiar with the phenomena found at the origins of the "new economy". This reveals that the universality of the values of science and technique knows no alternative to the evolution scale of the human society (Niculescu, 2006).

In the new economy, competitive advantage mainly belongs to those who are sufficiently informed and wise so as to know and admit that the true resources of the 21st century are knowledge, information, innovation, creativity, and intellectual capital.

Intangible assets have gradually become the most important sources of competitive advantage. According to the new perspective supported by the theory of endogenous growth and by other approaches, the traditional production factors (natural resources, labor force, and capital) have gradually reduced in importance. At the same time, the importance of intangible assets, such as information, knowledge, and creativity, has raised. Investments in intangible assets are important factors of competitiveness and convergence. While land, capital, and labor force are subject to the law of decreasing performance, knowledge and information trigger superior performance. The consequences are evident. Any progress in the line of competitiveness can now cause an avalanche of changes in the competitive landscape.

Through annual financial statements, accounting has the mission to reflect a faithful, real image of a company, by quantifying, registering, and recording transactions and economic operations. But in the new economy – the economy of information – the role of accounting is seriously questioned: how can we measure the intangible?

Just like Janus, accounting has two faces: a theoretical, scientific one and an operative one. In what concerns the adaptation to the intangible economy, theoretical accounting has made important steps by acknowledging the importance of intangible assets and liabilities, of knowledge as a production factor, but at the operational level

changes are slower, as the configuration of the traditional accounting system remains adapted to the industrial company.

The problem of informational asymmetry is highly complex in the knowledge society: as long as the accounting system will not be able to provide pertinent information on the real factors that create added value in a company, it will continue to lose ground, as the information provided become insignificant in the decision-making process.

In order to reduce the asymmetry between the information required by the management and that provided by accounting, professional international bodies and researchers have stressed the need to present in the annual reports additional information on the intangible capital (Kaufmann and Schneider, 2004). Lev and Zarowin (1999) plead for the extension of the scope of traditional financial statements to include the economic benefits generated by the intangible capital.

The Intangible Capital

The aspects related to the intangible capital are a challenge for the current economic thinking: this is not first of all an accounting concept, of interest for accountants as well as for managers, specialists in the fields of marketing, human resources, the information technology, sociology, psychology, education, and development.

In accounting, the term of **intangible capital** is often mistaken for intangible assets, although the latter are just a part of intangible capital. Indeed, intangible assets are elements of intellectual capital susceptible to be acknowledged as assets if certain recognition criteria imposed by international accounting standards are met (Meritum, 2002).

Accounting laws state that intangible assets are non-financial identifiable assets, with no material support, and owned in order to be used in the production process, in the provision of goods or services, in order to be lent to third parties or to administrative purposes.

The acknowledgement criteria (control, future economic benefits, credible cost measurement, and the separation from the commercial fund) must be met before an intangible asset can be recognized. For this reason, intangible assets can be considered as elements of intangible capital, but accounting norms do not allow its global acknowledgement and measurement.

One of the efforts made in order to raise the information level concerning intangible capital is the approval, in 2004, of the international financial reporting standard IFRS 3, which stipulates that the companies involved in business combination processes must identify and acknowledge the intangible assets they own. Therefore, according to IFRS 3, intangible capital becomes more "visible", and "the bed of Procust" of traditional accounting widens.

According to IFRS 3 – *Business combinations*, intangible assets acquired in a business combination, which correspond to the definition of the intangible asset and which can, therefore, be acknowledged separately because their just value can be credibly evaluated, are structured into five fields: marketing-related intangible assets (trademarks, service brands, collective brands, and certification brands, Internet domain names, clothing designs (unique color, shape, or package, newspaper headlines, non-competition agreements), customer-related intangible assets (lists of customers, the unsettled order or production portfolios, contracts with the customers and customer relations connected to them, non-contractual customer relations), intangible assets in the artistic field, intangible assets of a contractual nature, (licenses, copyrights, and innovation rights, publicity, construction, management, services or provisioning

contracts, lending/ leasing/ renting contracts, building authorizations, franchise contracts, operating and air rights, usage rights, such as: mining exploitation, water usage, cross-country rights, forest and road usage rights, service contracts, such as encumbrance service contracts, work contracts that favor the employer due to a contractual salary under the market salary level), technological intangible assets (patented technology, computer software and integrated circuits, unpatented technology, databases, commercial secrets such as: formulae, procedures, secret recipes). The identifiable assets in the 5 fields are the most frequent identifiable intangible assets that can be evaluated separately from the commercial fund.

Presentation of the Intangible Capital in Annual Financial Statements

Despite the accounting harmonization process, there still are discordant practices in what concerns reporting intangible capital elements, probably because of the complexity of intangible assets (Brannstrom and Giuliani, 2009). This seems to be Achilles' heel of the harmonization process...

Certain studies claim that financial statements are not appropriate and will never become appropriate for presenting intangible capital, and that special reports on the intangible part of the business are necessary (Mouritsen, 2006; Van der Meer-Kooistra and Zijlstra, 2001). However, information concerning the intangible capital, although in a simplified form, can be included in financial statements, especially since they are the main source of information on a dynamic market (Mouritsen, 2003).

Financial statements lose their relevance as the source of value creation in a global economy changes, residing in the intangible part of the asset (Grasenick and Low, 2004). It is therefore necessary to change the traditional accounting model, to include intangible assets in the analysis, with the purpose of obtaining a faithful image of the financial position, of the economic performane, and of their modifications.

Efficiency and effectiveness in customer relations, a correct management of the providers, obtaining guarantees, as well as preserving the partner loyalty are more than just "trendy" concepts in specialized literature, making the difference between the success or failure of a business and defining the ability of a company to coordinate and combine all the resources, be they endogenous or exogenous, in order to obtain a positive, sustainable, and raising final result. This combination of relations and interactions can be economically capitalized and, as a result, it represents a patrimonial element of the entity. The evaluation of these elements can be achieved only through the dynamic analysis of certain indicators and coefficients.

The knowledge society has a visible effect on the business environment, an influence translated through the appearance of virtual organizations and intelligent companies, and the intangible part of the total asset is in this case insignificant.

Under these circumstances, how relevant are the evaluation methods of the company? Are financial auditors really guarantors of financial information? Do they own the necessary resources and instruments to fulfill their mission?

In what concerns the evaluation of intangible assets, recent studies record significant progresses in the field: for example, the research team of the Australian Defense Department has created the CEVITA™ indicator – Capability Economic Value of Intangible and Tangible Assets, which encloses the value of tangible and intangible assets and the way they combine (Ratnatunga et al., 2004). Grimaldi and Cricelli (2009) defined a theoretical model for measuring the correlation between the value and type of intangible assets and the financial performance indicators. At the basis of this model lies the HAI index (*hierarchical assessment index*), which allows the identification of the key intangible assets for value creation in a company. The HAI index is the expression

of the combination of objective evaluation methods of intangible assets and the subjectivity of the evaluations performed by managers.

Traditional evaluation methods have been developed in order to determine the value of tangible assets, which explains the difficulties encountered in evaluating intangible assets.

Intangible assets are a critical component in determining the economic value of a company (Green, 2006). Taking into consideration both traditional indicators of the financial performance and the value of intangible assets will ensure the reflection in the annual statements of a faithful image of the results and decision-making based on credible information (Sriram, 2008).

In nowadays economies, traditional evaluation methods are ever more inappropriate and often irrelevant in determining the true value of a company.

A study performed by Wong in 2005 on the New Zealand companies quoted in the Stock Exchange revealed that in the absence of the amortization of the commercial fund and of the identifiable intangible assets there occurs a significant reduction of the value of the EV/EBIT (enterprise value to earnings before interest and tax) and PE (price to earnings) multiples used in the evaluation of the company, which leads to its over-evaluation. The conclusion is still valid only in the conditions of the inexistence of any depreciations of the commercial fund.

Conclusions

Knowledge is profitability and power.

However, accounting is unable to render this reality through financial statements: in the knowledge society, intangible capital is the key resource of the competitive advantage.

Ever more useless for the top management in the leading process, the current financial management systems live their last days... One of the accounting principles requires connecting the expenses to the incomes... How can this principle be met since knowledge is not subject to traditional economic laws? If most tangible assets decry, lose their value as a result of their usage in the economic activity, the use/reuse of intangible assets increases the value of the latter. In a metaphoric statement, we could say that as long as we keep measuring the new with the instruments of the old, we will never "see" the new...

We live in an information era, in an economic environment based on knowledge, in a global network society. However, accounting is based on principles mostly formulated by Luca Pacioli in 1494. There are, of course, adaptations and improvements of this system in time, including the usage of IT systems, but unfortunately these improvements do not evolve at the same speed as business today.

Accounting must give up the old methods, since its reticence in acknowledging and using the intangible part of the business is an obstacle to raising the performance of the company.

The new economy requires the transformation of the traditional accounting system!!!

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