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Article

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IS THE FUTURE OF ACCOUNTING COMPATIBLE WITH THE ACCOUNTING OF THE FUTURE?¹

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Abstract: *Purpose – There is currently a tendency to reverse the relation between physical and intangible assets, in favor of the latter, which triggers the need to pay an ever higher attention to intangible assets. This article aims at presenting the relativity and inconsistency of the current accounting systems and does not claim to suggest an alternative. Conclusions – Intangible assets are the most important resource that companies have in the process of value creation, but accounting balance in what concerns acknowledging, evaluating, and presenting intangible assets is only in an initial stage, in spite of the efforts made by national and international accounting bodies.*

Keywords: accounting, intangible assets, market value, accounting value, e-commerce.

JEL Classification: M41, L81

The future depends on our lucidity.

Augustin Buzura

1. INTRODUCTION

The idea of this material is simple: it is fundamentally wrong for the accounting system not to adapt to the evolution of the current business models, an evolution largely determined by technological progress.

After Babel, we are all locked in language, in our own constructs on reality. If there were a universal language of accounting, with common rules, concepts, and practices for all the countries, understanding would be instantaneous, spontaneous. But, however, this idea has not materialized yet. Attempts continue... Like any revolution, the one in the accounting field is justified through

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ideas. Accounting is an art, a science, as well as language, a technique nurtured not only by past knowledge, generated by practice, but also by the results provided by research. Leaving hybrid formulae aside, it is difficult to accept with undeniable arguments that the subject we serve, accounting, is a science, since the truth is that this field operates in almost equal proportions with objectivity and subjectivity.

Although the business world has suffered significant mutations in time, the accounting system is still ruled by traditional production factors, ignoring the importance of knowledge as a production factor and as an element of the financial health of the company. Knowledge is not subject to traditional economic laws: if most physical assets decay, they lose some of their value because of their usage in the economic activity, the use/reuse of intangible assets increases their value.

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

2. EVALUATING THE INTANGIBLE ASSET IN A KNOWLEDGE ECONOMY

Intangible assets are, at present, the key to the economic success of any business, especially as we live in an information era, in an economic environment based on knowledge, in a global network society (Petty and Guthrie, 2000).

In the vision of the International Evaluation Committee, IVSC, in the General Standard for Practice in Evaluation GN 4, the revised edition 2010, intangible assets are non-monetary assets manifested through their economic properties. They do not have any physical substance, but grant economic rights and benefits to their owner or to the owner of a part of them. According to the same standard, intangible assets can be grouped into: assets derived from rights, assets based on relations, grouped intangible assets, and intellectual property.

The definitions of intangible assets provided by the main accounting bodies are similar, as all stress the fact that intangible assets are assets with no physical and monetary substance, owned by the company as a result of past events, and which will generate future economic benefits.

The value of a company is mainly given by its intangible assets, defined by Lev (2003) as resources without physical substance, which will generate future economic benefits for the company that owns them. Considering the importance of the intangible asset in obtaining competitive advantages, the efforts of the companies focus more and more in the direction of its identification, acknowledgement, and correct evaluation (Marr and Schiuma, 2001; Cañibano et al.,

2002; Marr, 2004; Bueno et al., 2004; Gray et al., 2004; Roberts and Breunig, 2004; Augier and Teece, 2005).

In time, intangible assets have been considered high risk assets. However, in nowadays economies, the real value of a company results from its intellectual capitalul, which, in the opinion of Edvinsson and Malone (2000), includes human capital (knowledge, skills, and competences of the employees), structural capital (the infrastructure that supports the activity performed by the employees: buildings, hardware, software, processes, patents, trademarks, the organizational structure, information systems, and databases), innovation capital (intellectual property and intangible assets, defined as the set of skills and theoretical knowledge that ensure the functioning of the company), and relational capital (the relations with the customers and the providers, gaining their loyalty).

Accounting professionals have directed their attention towards the analysis of intangible assets at the beginning of the 1980's, often calling them goodwill. Later, towards the middle of the 80's, the concept of intellectual capital has been introduced as a result of the interest shown by the large quoted companies in calculating the difference between the accounting value and the market value of the company (Edvinsson and Malone, 2000; Roos et al., 2001; Andriessen, 2004).

But what means measuring and evaluating knowledge in a knowledge economy?

The acknowledgement criteria (control, future economic benefits, credible cost measurement, and separation from the commercial fund) must be met before an intangible asset can be acknowledged. One of the most difficult criteria to be met is the credible cost measure. Supposing that this condition can be fulfilled, intangible assets are initially evaluated at their own cost, respectively at the input value: purchase price, production cost, vendor's asset or just value.

Generally speaking, internally created intangible assets are not acknowledged, except for intangible assets acquired from third parties.

If most companies perform periodic patrimony and financial evaluations, very few do the same in what concerns intangible assets, since their intangible nature is incompatible with the precision required by their evaluation. The evaluation of intangible assets is harder to achieve as standardized criteria are not identified to this purpose.

It is unusual to have an active market for intangible assets. For instance, it is impossible to have an active market for patents and trademarks, considering that each asset is unique. When a current price cannot be obtained, the price of the most recent similar tranzaction can provide a sufficiently reasonable basis for estimating the just value. Where an active market does not exist, the cost will be the amount that an entity should pay for an asset, in a tranzaction made willingly between the informed parties and where the price has been established objectively. For example: an

entity owns a football team and it decides to sell a defenceman and buy an assailant. Also, several similar entities are involved in the process of selling-buying the players and there is an active market of the players who are transferred from one entity to another. The price to be paid or received will depend on how much the other entities on the market are willing to pay.

Because of these reasons, it is necessary to analyze if the cost (the just value) of an intangible asset can be credibly evaluated and, if possible, to periodically re-evaluate its just value in order to ensure that the accounting value is not significantly different from the value that would be computed using the just value at the balance date.

A price obtained on an active market will provide the most credible estimation of the just value. The just value is, according to IAS regulations, the amount for which an asset can be sold or a debt can be discounted, willingly, between informed parties, in a transaction where the price is objectively computed. Similarly to the concept of faithful image, the just value expresses an extremely wide approach, which can always be improved. For this reason, the basis of the just value has to be centered on the market value. No just value is just and relevant if the market (the buyer) does not acknowledge it as such (Horomnea, 2008, p.380).

A number of studies (Brennan, 2001 and Gröjer and Johanson, 1998) have pointed out the differences that exist between the market value of a company and its net accounting value, as a result of the presence of intangible assets, which has led to a concentration of the efforts in order to identify and quantify the “missing assets”. For example, the 2004 statistics showed that the market value of Microsoft was 286.2 billion dollars, while its financial value was only 57.5 billion dollars, which means a ratio of 5:1 in favor of intangible assets. For eBay, the market value was 54.5 billion dollars, and the financial value 4.9 billion dollars, resulting in a ratio of 11:1 (Dess, Lumpkin and Eisner, 2006, p.119).

The presentation in annual statements information on intellectual capital triggers a series of advantages in comparison with its acknowledgement and evaluation. On the one hand, the standards drawn by accounting bodies are restrictive in what concerns the acknowledgement and evaluation of the intangible asset, and on the other, the identification and measurement of the asset elements that determine the difference between the net accounting value and the market value imply additional costs. Many of the solutions suggested in order to solve the “problem” of intangible assets are based on the provision of supplementary information concerning the intangible asset in the annual statement.

The presentation models of such information (often including measuring elements to be used internally by the company) have started to be used at the end of the 1980's. The Swedish company Skandia has developed its own model for reporting the information concerning intellectual capital.

The *Navigador Skandia* model identifies three components of intellectual capital: human, structural, and relational, and uses for its evaluation 90 elements, classified into 5 groups, namely: financial (20), human (13), processes (16), clients (22), innovation/development.

Sveiby (2001) has developed the *Intangible Assets Monitor*, a model that evaluates intangible assets under 4 aspects: growth, innovation, usage/efficiency, and reducing risks/stability.

Balanced Scorecard is a management and optimization system of the execution of the strategy of an organization, which allows the company to gain an accelerated increase in its operational performance and to meet the strategic objectives defined. Initiated by Robert Kaplan and David Norton, *Balanced Scorecard* has been adopted by thousands of companies worldwide, which are using it successfully, reaching what Kaplan and Norton (1992) name “The Execution Premium”.

3. “TO PREPARE THE FUTURE ONLY MEANS CREATING THE PRESENT...”

In spite of the efforts concentrated on achieving an *international accounting harmony*, in what concerns the publication of information regarding intangible assets, we cannot speak of a convergence towards the international accounting norms (Brannstrom and Giuliani, 2009, Lhaopadchan, 2010). Although it is possible for accounting harmony never to be attained, the annual financial statements need to include a minimum of information on intangible assets in order to support the decision-making process of the users. To this purpose, companies could use additional documents to correct what is missing from the traditional financial-accounting reporting system (Mouritsen, 2006). The intensification of competition, the development of new business segments and technological progress have all lead to the deterioration of traditional financial statements (FASB, 2001b).

Financial statements lose their relevance as the source of value creation in global economy changes, residing in the intangible part of the asset (Grasenick and Low, 2004). It is required to alter the traditional accounting system so as to include intangible assets in the analysis, with the purpose of obtaining a faithful image of the financial position, of the economic performance, and of its modification.

There are, in essence, two different approaches, although not necessarily disjunct, in what concerns the accounting of intangible assets, of intellectual capital. In case intellectual capital or some elements in its composition are regarded as usage value assets, it is logical to determine this value and for it to be acknowledged in the balance. The other approach suggests presenting information on intellectual capital, without attributing it any monetary value (Gowthorpe, 2008).

The users of financial statements are primarily interested in the information on intangible assets, especially that they are considered to be the catalysts of value creation for the company. In order to meet the needs for information of the various users, some companies draw special reports where they present the nature and value of intellectual capital, structured into: human capital, structural capital, and relational capital (Castilla Polo and Gallardo Vázquez, 2008).

In a globalized economy, based on knowledge, intangible assets become an important source for the aggregate value of a company and for its financial stability.

In specialized literature, few studies have been concerned with the manner in which financial analysts use the information on intangible assets. García-Meca and Martínez (2007) have shown that, in over 70% of the analyzed cases, financial analysts present information on the new investments, on the credibility of the company, on the adopted strategy, as well as on the partnerships and agreements closed with other companies. The same study stresses the fact that annual financial reports do not include information concerning the innovation, research, and development activities because, on the one hand, such intangible assets are difficult to measure and, on the other, in order not to provide information that could be used by competition.

There is a direct relation between the profitability of companies and the amount of information regarding the intangible assets presented in annual reports (García-Meca and Martínez, 2007). Widener (2006) concludes that presenting a larger amount of non-financial information is highly important in the monitoring and control process of the companies. In nowadays economy, intellectual capital is considered a critical resource for ensuring a real and sustainable competitive advantage (Marr *et al.*, 2002, Steenkamp and Kashyap, 2010).

Carlucci *et al.* (2004) proves that the management of intellectual capital decisively influences the performance of the company. But *the accounting of intellectual capital does not successfully integrate with the traditional accounting and reporting model*. The main problem comes from the fact that, while the traditional accounting system takes into consideration both the assets and the liabilities of the own capital, intellectual capital, as it has been theorized until now, includes only assets, ignoring intangible liabilities. Also, any effort to measure intellectual capital is subjective, and therefore little credible from an ethical point of view (Gowthorpe, 2008).

If we admit the existence of intangible assets and determine their economic value, we cannot omit their provenience, the way they are funded, in other words, we must also acknowledge intangible liabilities (García –Parra *et al.*, 2009). Among them, we distinguish between own capitals (more specifically, hidden resources) and attracted funds, or debts.

Hidden resources are those that are not mentioned in financial statements, representing the difference between the purchase price and the market value. The part of intangible assets funded from the own capital implies the existence of hidden reserves with an equivalent value.

Intangible assets can also be used to attract foreign funds. This is not only a theoretical possibility, since practice already proved the existence of financial operations where intangible assets are used as guarantees for obtaining long-term loans.

In an economy based on knowledge, it becomes an imperative to identify and locate intangible assets in the functional departments of the company and to determine their influence on the performance of the entity (Chareonsuk and Chansa-ngavej, 2008).

4. CONCLUSIONS

Just like Janus, accounting has two faces: a theoretical, scientific one and an operational 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 operationally the changes are slower, as the configuration of the traditional accounting system remains adapted to the industrial company.

The accounting system has to extend its span at the level of intangible assets so as to truly reflect the economic reality. Intangible assets are the most important resource of the companies, especially those in the e-commerce field. The definition, the acknowledgement, the measuring, and the continuous evaluation of intangible assets, as well as the presentation of financial information on the intangible asset represent the premises for obtaining valid, complete, and relevant information in decision making.

The topic above is highly complex, and this material is intended only as an alarm signal, which records the relativity and inconsistency of the current accounting system, without claiming to suggest an alternative.

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