Objectivity is the main pillar on which the existing financial accounting system rests. But there involves a great deal of subjectivity in the valuation of intangible assets. This is particularly true in the case of valuation of homegrown intangibles, which are mostly non-verifiable. When subjectivity plays a major role in the valuation of an item that is non-verifiable, accountants get enough scope to employ ‘creativity’ in accounting. So if homegrown intangibles are allowed to be included in the balance sheet, creative accounting, it is suspected, will be rampantly practised. That this fear is not exaggerated is clear from the accounting practices of some British companies in the late 1980s. Those companies all on a sudden started to report their brand names as intangible assets in their balance sheet taking the advantage of the absence of any concrete accounting policy for such assets. This practice was ultimately prohibited as it lacked credibility.

Many accountants are in favour of keeping homegrown intangibles outside the balance sheet as they are not verifiable. They opine that if the financial accounting, which has been developed over so many years through the researches of academicians and practitioners, is to maintain its credibility, it must get rid of this kind of ‘soft’ assets. Many users of financial statements are also sceptical about the authenticity of values to be attributed to intangibles. As per Brand Finance’s Report (1999) of a study in UK, nearly 4 out of 5 analysts believe that brand valuations based on director’s estimates will lead to creative accounting (Bartram, 2000). In the survey it has been seen that 2 Software companies are valuing their brands based on different perceptions although they are using the same model. For example, in valuing brand as on 31st March 2002, while Infosys assumed 6% inflation per annum, Satyam considered 2% inflation per annum. Selection of brand multiple was done by the companies based on the internal evaluation of some common parameters. Similarly, human resources valuations have been done by these two companies based on different assumptions although the Lev and Schwartz model has been used by both. So valuation of homegrown intangibles is purely arbitrary and non-verifiable. Moreover, if the present value of the estimated future earnings of employees is taken
as the measure of the value of human resources, as is done in the Lev and Schwartz model, and that is shown as assets in the balance sheet, most of the loss-making concerns, like SAIL considered in the survey, will get a unique opportunity to wipe out their accumulated loss. That will bring a great confusion in the corporate world. That is why, possibly, standard-setting bodies of different countries are quite hesitant to allow incorporation of homegrown intangibles in the balance sheet.

Again, keeping intangibles outside the knowledge of the investors and shareholders will be a great injustice to them. This is particularly true in case of brand- and knowledge-based companies where more than two-third of the real values of the firms, as has been seen in the survey, remains absorbed in the intangibles. So even if measurement of intangible can not be done reliably, their disclosure, at least, should not be ignored in case of those companies where they matter most. In fact, disclosure of such assets is required for understanding the earnings prospect and future cash flow of those companies. The Financial Accounting Standard Board (FASB) of the USA says that accounting’s fundamental purpose is to “provide information that is useful ..........in making rational investment, credit and similar decisions.” But how can a software- and technology- based company provide this information if it does not disclose its intangible assets which are its main value drivers?

Moreover, it seems illogical to differentiate between purchased intangibles and homegrown intangibles in respect of their accounting. For example, X Ltd. has invested Rs.100 crores to develop a brand. As it is internally developed, X Ltd. can not show it in its balance sheet. Now, Y Ltd. purchases the same brand from X Ltd. for Rs.100 crores. As the brand is purchased, Y Ltd. is entitled to show it in its balance sheet. So the same asset gets recognition when it changes hand. Even this kind of asset is not allowed to stay in the balance sheet for long. For instance, in our survey it has been observed that HLL is amortising the cost of the ‘Lakme’ brand that it acquired for Rs.110 crores, only over a period of 4 years although it is likely that the company will be enjoying the benefits out of this brand over several years. This does not seem to be logical. Software is another example, which does not get fair accounting treatment. When a computer is purchased, it is treated as an asset in the balance sheet, but software, homegrown or purchased, is generally treated as an expense. This is evident in our survey where it has been found that only two companies have capitalised software development expenses. That does not make any sense—often the software has a longer life than the computer. Further, software is a kind of finished product, not a kind of raw material. Similarly, accountants
do little justice to the users of financial statements when they omit the patent portfolio from the asset base of a Biotech company or expense away the cost of training imparted to professionals like engineers and accountants for ensuring growth and prosperity of the company. In fact when a cost is booked as an asset, it is there for investors to see. The company has to report to the investors every year how efficiently the asset is being used for earning return. By contrast, if a cost that is supposed to generate long term benefit is expensed away immediately, it disappears from the eyes of the investors. The Management does not have any accountability to produce return on it.

Very often it is feared that the existing financial statements which are based on objective facts will become unreliable if intangibles are allowed to be incorporated in the balance sheet. It is argued that valuation of an intangible is highly subjective and a high degree of risk is generally associated with it. The future outcome from it may range from zero to a large amount. But the claim that the existing corporate financial statements convey objective facts is exaggerated. Barring cash, almost all items in the balance sheet are based on the subjective estimates about the future. A few examples are as follows:

- The net value of accounts receivable depends on manager’s estimates concerning future customers’ defaults.
- The net value of property, plant, and equipment depends on the manager’s estimate of depreciation.
- Obligations for pensions and post-retirement benefits rely on long-term assumptions concerning future wage increases and the rate of return on investment.
- The firm’s provisions for product warranties or insurance claims are based on estimates of future payments of these obligations.

Thus it can not be said with certainty that the existing accounting system which is focused on measurement and reporting of physical assets is a full proof system. In the present business world where continuous innovation is the prerequisite for survival, future outcome from tangible assets is also becoming highly uncertain. A machine involving huge investment may become obsolete overnight due to the emergence of a new kind of machine or the product becoming out of fashion. So the question naturally arises whether tangible and intangible assets should receive different accounting treatments.
As intangibles are increasingly becoming the main value drivers in many companies, users of financial statements demand the disclosure of more information about intangibles. Market forces are supposed to ensure that a demand for information on intangibles will be met by adequate supply. But the information revelation principle has failed to operate in case of intangibles. The study conducted by the Financial Accounting Standard Board (FASB) of the USA regarding voluntary information disclosure by public corporations concluded that "the steering committee was pleasantly surprised to discover that companies presently are voluntarily disclosing an extensive amount of useful business information ....... The results of the over-all study included some disappointments. One was the general lack of meaningful and useful disclosures about intangible assets." (Lev, 2001). The FASB's findings of extensive disclosure of useful business information is consistent with the information revelation principle. But that is not happening with intangibles. Lev has ascribed the intangibles' information failure to the complex web of motives of the major players in the information area: managers, auditors and financial analysts. Managers usually prefer immediate expensing of investments in intangibles -- both internally developed and acquired -- for inflating future reported profit. Moreover if the intangible acquired or homegrown, fails to click, it has to be written off in the financial statements publicly. This may trigger questions about the reasonableness of acquisition or development of the intangible and, possibly lawsuits. The immediate expensing of investment in intangible obscures such failure and obviates the need to provide explanations.

Auditors are also not very comfortable with these risky assets. As they may be blamed for certifying those assets in case of their subsequent failure, they generally insist upon their immediate write off. Financial analysts are also reluctant about the disclosure of information regarding intangibles. They are generally well-connected persons and obtain sufficient information from managers (via conference call, background briefings, and so on) about firms' innovation activities. In fact, public disclosure of such information in the financial statements may strip them of this privileged information.

The problem of information asymmetry is not just a theoretical issue. It is likely to lead some serious private and social consequences. Firstly informed persons (such as managers having information about the success of a drug under development in clinical tests) would gainfully trade to exploit their private information. The substantial gain of insiders will be accompanied by the corresponding losses to general investors. This will impair the investors' confidence in the integrity of the capital market. Secondly, information asymmetry increases bid-ask spread.
of securities. The widening spread implies high transaction costs to investors. This will force the investors to demand for higher returns. The demand for higher return implies a higher cost of capital. The high cost of capital is detrimental to investment and growth.

The adverse private and social consequences of information asymmetry are corroborated by a number of empirical evidences. Boone and Raman (2001) examined the consequences of information asymmetry created by R&D. They found a statistically significant association between increase in R&D expenditures and widening of securities spread and consequent increase of cost of capital. Lev and others have also found from a study involving 1500 companies that growth in R&D is accompanied by declining market value of a firm. The reason is not difficult to comprehend. As R&D are mostly expensed away, profitability is impaired drastically. Hence the investors heavily discount the prospects of the company. So the result is the undervaluation of the firm. The harmful social consequences are obvious: companies that invest consistently in intangibles are not sound performers as far as their financial measures are concerned, tend to have high cost of capital imposed on them by capital markets and get their investment and growth retarded.

We should not also ignore the social harm the existing accounting practice in respect of intangibles is causing in another way. Since investment in intangibles is mostly expensed in the income statement immediately, the management very often becomes tempted to use it as earnings management tool. Evidence indicates that immediately before the public offerings, they curtail R&D expenditure in order to improve the bottom line so that investors' perception about the company’s prospect becomes high (Lev, 2001). Surprisingly, some companies even publicly announce a cut in investment in R&D for boosting profit. For example in a report to investors, Kodak's chief financial officer declared, according to the Wall Street Journal, September 27, 2000 that Kodak was considering “belt-tightening measures, including a cut in digital (cameras) R&D”. So the company was harming its long-term prospect to meet short-term earning targets. Had the accounting rule for intangibles been different i.e., if they were allowed to be capitalised, the company need not have taken such retrograde step.

That conventional financial statements are not conveying much useful information, specially in the case of knowledge-based companies, is evident from the poor correlation between earnings and stock price changes as found out in the survey made in the preceding chapter. It has been noted in the survey that correlation between earning and stock price changes is very poor almost for all brand and knowledge based companies in the sample. This same pattern of association
between corporate earnings and stock price changes was found by Lev in case of approximately 5000 U.S. companies over the period 1980-96 (Lev, 2001). Had the message from financial statements been useful, such result would not have been found.

Accounting is a dynamic social science. It is expected to act as a medium for communicating useful and relevant information relating to the organisation to different concerned parties. If the information requirement of users changes because of changing socio-economic conditions the existing accounting system has to be redesigned and adapted to the changing needs. Accordingly, intangible assets, which act as main value drivers in the knowledge economy, should be disclosed, at least, as supplementary information if they can not be objectively measured and accommodated in the balance sheet. However, the survey of accounting and reporting practices in India relating to intangibles reveals that the Indian companies in general are yet to understand the importance of intangible assets in the emerging new economy. Most of these assets remain almost unreported in the balance sheet. Except Infosys, all other companies in the sample are either not discussing or are casually discussing their intangibles outside the balance sheet.

SUGGESTIONS

The present financial reporting system considers only financial information based on historical transactions and events. It is more focused on catering the needs of present and potential investors. It emphasizes more on reliability than relevance. However, in the emerging knowledge-based business environment, the business reporting model should
- consider both financial and non-financial information
- not only provide historical information but also forward-looking information
- meet the needs of investors as well as other users.

The proposed reporting model prepared in line with the framework proposed by the Accounting Standard Board (ASB) of UK should fulfill a number of criteria, viz., relevance, reliability, compatibility and understandability. The proposed reporting model is shown in Figure 19.
The following observations are relevant.

a) The proposed business reporting model does not discard the historical-based financial statements comprising the profit and loss account, balance sheet and cash-flow statement. However, the information to be contained in those statements should be reliable. The reliability criteria should comprise three subsidiary qualities – truthfulness, fairness and neutrality. In other words, in order to be useful, the information should be true, fair and neutral. Generally financial statements are said to reflect a true and fair view when they are prepared in compliance with the
GAAPs (Generally Accepted Accounting Principles). However, the existing GAAPs focus on the measurement and recognition of physical assets. Intangible assets, which are now increasingly regarded as the main value drivers of the company in the knowledge economy, have not been given any importance by it. Financial statements are, therefore, unlikely to reflect a true and fair view of the affairs of the company. So the GAAPs should be revised to make the financial statements reflect a true and fair view. For this purpose, the following changes are suggested in connection with the preparation of financial statements.

1) The arbitrary amortisation of acquired intangibles like brand, goodwill etc. over the maximum period, as specified by the AS 10 and AS 26 issued by The ICAI, or even earlier, should be dispensed with. Rather, they should be written off according to impairment test. Unless the impairment test indicates diminution in their value, they should be treated as permanent assets.

2) The costs of developing brands, patents, software, training etc. should be capitalised and shown as assets in the balance sheet, if they are expected to generate cash flow to the firm in future. Often these assets have long lives. Hence, they should not be amortised over a predetermined period say, 3 or 5 years, as is the practice now. They should be written off according to periodic impairment test. For this purpose, suitable amendments in the AS 10 and AS 26 should be made.

3) It has been noted in the survey that no company in the sample is capitalising development costs. In fact, AS 26 requires capitalization of development costs when they fulfil some conditions. But companies act as if development costs fail to fulfil those conditions. This attitude needs change. Development costs, which fulfil the required conditions as laid down in AS 26, should be capitalised and brought to the notice of the investors so that they can have an idea of the company's future prospect.

b) Information to be contained in the proposed reporting model should be relevant for decision making. Relevance comprises three subsidiary qualities – timeliness, predictive value and feedback value. Timely dissemination of information is vital for decision making. If information is not served in time, its relevance is lost. So for attaining timeliness, we recommend the continuous dissemination of information about the business online along with
the published annual report. The management should take the opportunity of direct communication with all stakeholders created by information technology.

Predictive value criterion enables the stakeholders to assess the future prospect and growth potential of the business. The business should provide the stakeholders with those information based on which they can make prediction about future profitability and cash flow. The stakeholders can make prediction about the business by three possible methods (AICPA, 1994):

1) study information about the past and the present to make an insight about the future;
2) search for leading indicators in historical data i.e., existing conditions that provide insight into the future (e.g., trend analysis; performance measures of how well a company performs key business process; correlated measures i.e., conditions closely correlated with a company's future performance); and
3) search for forward-looking information, which includes management's plans, assessment of opportunities, risk and forecasted data. Estimating or predicting information, therefore, presupposes that management discloses certain key information about past, present and future activities relating to operations of the company such that prediction or estimation becomes reasonably feasible.

In order to enhance the predictive value of business reporting, some non-financial statements should accompany the conventional financial statements. In some advanced countries like the USA and UK the regulatory authorities require large companies to give commentary in the annual report on the strength and resources of the business that are not reflected in the balance sheet. Examples of the subjects that are generally included in the commentary are (a) corporate reputation and brand equity, (b) intellectual capital, (c) licence, patents, copyrights and trademark, (d) R&D, (e) customer and supplier relation (f) market position (g) management's plan for future (h) opportunity and risks etc. This commentary known as MD&A (Management Discussion and Analysis) in the USA and OFR (Operating and Financial Review) in the UK are very helpful to the users of annual reports in assessing the future prospect of the company. In India the Securities and Exchange Board of India (SEBI) requires every listed company vide clause 49 of the Listing Agreement to state in the Corporate Governance Report “whether MD&A is a part of annual report or not.” Taking the advantage of flexibility of the rule a company may skip giving MD&A in the annual report. So the existing provision should be deleted and a new provision be incorporated making MD&A mandatory. Moreover it has.
been observed that as SEBI has not stipulated any hard and fast rule regarding the contents of MD&A, companies are providing information in the discussion according to their own discretion. So there is no uniformity in the reporting of information. SEBI should, therefore, come forward in prescribing the areas to be discussed in the MD&A.

During the last ten years or so, many authorities have developed different models for reporting Key Financial Indicators (KPIs) of business, both of financial and non-financial nature, keeping pace with the changing business environment. Those models have been discussed in Chapter-1. None of these reporting models has received any recognition by the standard-setters or regulatory authorities. Consequently, companies in general do not bother to follow any of these models for giving various non-financial information. But the information sought to be given through those models is very much useful in assessing the growth prospect of the company. However following all those models for giving non-financial information may lead to a situation of over information which is both confusing and costly. So we suggest that regulatory authorities like SEBI should make it mandatory for the companies to provide non-financial information following models such as Sveiby’s Intangible Assets Monitor and Lev’s Value Chain Scorecard.

Information should be comparable and understandable. National difference in corporate reporting or performance measurement “cause loss of investor confidence and strongly influence the availability and cost of capital” as said David Illingworth, President of the Institute of Chartered Accountants in England & Wales (ICAEW) speaking at an Economic Summit in Beijing, China on 21 May 2004. He said this is because “investors build in a premium to their lending if there is uncertainty or lack of comparability about the figures – sometimes as much as 40%.” Comparability involves (a) inter-firm comparison; (b) inter-period comparison and (c) internal comparison. To make the information comparable, different types of accounting treatment for homegrown intangibles and acquired intangibles, as practiced now, should be stopped. Similarly there should be consistency in the application of the accounting policy year after year. Moreover the information should be clear, unambiguous and transparent if it is to be understandable. A statement eulogizing the brand or human resources, as is the practice of many companies does not convey much meaning. Rather, information like market share of brands, value added per employee, research and development, intellectual properties etc. are more useful to the stakeholders.
It suggested that the apex accounting bodies in each country should set up a separate body of valuers more or less in the same line as the body of Chartered or Management Accountants or Actuaries. Independent registered valuers should be assigned the task of valuation of intangibles (as also tangibles) based on certain standard parameters and data from the concerned companies. It is expected that over time such valuers would acquire considerable mastery in this field.

In order to make the financial statements compatible with the knowledge-based business environment, the following changes in the Companies Act are suggested:

1) The Profit and Loss Account: At present the Companies Act does not specify any specific format of profit and loss account. This has resulted in diversity in practices. It has also been observed that profit and loss accounts prepared in vertical format by all sample companies have been focussing on the present profitability. This format was compatible with the industrial economy. In the knowledge economy, the financial statement should equally focus on growth and future sustainability. So the profit and loss account should better be renamed as operating statement which should give information on segments of operation preferably product-wise. The proposed format of the operating statement is given in Table 52.

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The sort of presentation of operating statement depicted above is likely to enable the stakeholders to know how much the company is spending for producing things to sell or for rendering services, how much for taking care of customers and how much for ensuring sustainable development. The practice of clubbing all expenses – manufacturing, administration and selling, as is being done in many cases (e.g., TISCO,) might have been acceptable decades ago but not now.

2) The Balance Sheet: At present companies are required to prepare balance sheets in compliance with Schedule-VI of the Companies Act. Schedule V1 requires the disclosure of intangible assets along with physical assets under the head Fixed Assets. As intangible assets
are now assuming greater importance, they should be separately shown in the balance sheet. With this small modification, the present format of balance sheet may be retained.

Very often experts highlight the deficiency of the existing accounting system because the balance sheet of a firm does not reflect its market value. But the notion that the balance sheet of a firm should reflect its market value appears to be a misguided one. The disparity between the book value of a firm and its market value is not simply due to missing intangibles. The two figures are arrived at in two different ways. The book value is arrived at after applying a body of accounting principles and conventions to transactions and events that have already occurred and is essentially a historical perspective regardless of how assets and liabilities are measured. The market value, on the other hand, is the result of a number of factors. A company’s market value may be decomposed in the following way:

**Accounting book value**

+/- Market assessment of values of recognised assets and liabilities

+/- Market assessment of value of items that meet the definition of assets and liabilities but are not recognised in the financial statements

(For example, acquired brand immediately written off)

+/- Market assessment of intangible value drivers or value impairers that do not meet the definition of assets and liabilities (for example, employee morale)

+/- Market assessment of company’s future plans, opportunities and risk

+/- other factors such as market psychology, pessimism etc.

**Market value**

So market value of a company is influenced by many factors which can not be financially measured. However effort should be made to explain the gap between the two figures. This, of course, does not suggest discarding the transaction-based balance sheet. The transaction-based balance sheet will continue as usual. Along with the traditional balance sheet, a value-based balance sheet may be introduced. In the value-based balance sheet, current assets, fixed assets and investment will be stated at market values or at values determined by the Registered Valuers as suggested above. Along with them may also be placed a set of intangibles, viz., R&D, brand and people. The R&D may be stated at cost or, if possible, at the present value of incremental...
cash flow likely to be arising from them. The brand may be valued using the Brand Multiple Method as developed by the London-based firm, Interbrand, and the human resources may be valued on the basis of Lev & Schwartz model as these are the most popular and accepted models. Then a Trend Analysis may be done to see how the market value of the firm is behaving with respect to its fair value over a period.

3) Disclosure of Accounting Policies regarding Intangibles and Compliance with Accounting Standards: It has been observed that accounting policies regarding intangibles are generally being disclosed along with accounting policies regarding physical assets. This dilutes the importance of intangible assets. The accounting policies regarding intangibles should be disclosed separately and prominently. This will enhance the understandability of financial statements.

Regarding compliance with accounting standard, Sub-sections (3A) and (3B) of section 211 of the Companies Act, promulgated by the Companies (Amendment) Ordinance of 1998 and 1999 states as follows:

"(3A) Every profit and loss account and balance sheet of the company shall comply with the accounting policies.

(3B) Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely, (a) the deviation from the accounting standards; (b) the reasons for such deviation, and (c) the financial effect, if any, arising due to such deviation."

Sub-section 3(1)(d) of section 227 of the Act which deals with powers and duties of auditors, requires an auditor to state:

"(d) whether, in his, opinion, the profit and loss account and balance sheet complied with the accounting standards referred to in sub-section (3C) of section 211."

Sub-section (3A) requiring preparation of profit and loss account and balance sheet in compliance with accounting standards is undoubtedly a right step. However Sub-section (3B) dilutes the rigour of sub-section (3A) as it requires the disclosure of non-compliance of accounting standard only, if that happens and does not stipulate any penal provision for non-compliance. This may encourage some unscrupulous managers to write off intangibles prematurely with some undesirable motive. Moreover, there should have been a provision for qualification in the audit report for
non-compliance with accounting standards.

Limitations of the Study

The present study suffers from certain limitations stated below:

1) A decisive conclusion depends to a large extent upon adequacy of data. The sample consists of only 30 companies within the top 50 companies ranked in terms of market capitalization in India. Thus, only large and established companies have come in the sample. Therefore, it cannot be generalised that the relatively smaller but renowned companies, ranked lower in terms of market capitalization, are following the same pattern regarding the accounting and reporting of intangibles.

2) In this study, total intangibles of sample companies have been worked out on the basis of the Market Value to Book Value concept and attempt has been made to examine whether the balance sheet of a company should be made to reflect its market value. But the other methods of measuring intangibles in a comprehensive manner have not been tried out because of non-availability of requisite data. It has been noted above that the difference between market value and book value does not depend solely on intangibles. The segregation of the effect of intangibles and other factors has not been possible in this study, as it is rather a difficult task.

Given all these limitations, the study has made a modest attempt to fulfil its objectives and identified the current trend in accounting and reporting of intangible assets in India in the corporate sector.

Scope for Further Research

The researcher would like to focus on some areas mentioned below where further research on intangibles may be carried out

1) It may be explored whether the definition of assets can be given a different look with a view to capturing the whole range of intangible assets.

2) Research may be undertaken with a view to designing an effective framework of accounting for measurement and recognition of the whole range of intangible assets.
3) As the AS 26 (*Intangible Assets*), has been introduced w.e.f. 1.4.2003, research may be undertaken to see how far the Indian companies are complying with the requirements of this new Accounting Standard.

4) Study may be conducted to assess the perceptions of users of annual report vis-a-vis the necessity of accounting and reporting of intangible assets.

The researcher further observes that in line with the issues raised by The ICAEW (2004), further research may also be undertaken in at least some the following areas particularly with respect to intangibles:

1. Evidence of misallocation of resources in the recent technology boom and the extent to which this is attributed to shortcomings in the traditional financial reporting model
2. How managers and external investors actually take investment decisions in the absence of any significant financial statement information
3. Which Key Performance Indicators (KPIs) have, with the benefit of hindsight, represented good predictive indicators of business performance and value
4. Whether the internal and external users of business reports understand and find useful information that is based on complex valuation models (e.g. for certain intangibles) and potentially volatile market prices
5. To what extent share price volatility and stock market cycles are attributable to shortcomings in the usefulness of business reporting rather than to factors such as underlying economic cycles, inherent uncertainty and herd-like behaviour patterns
6. The practical experience of companies that have implemented new reporting models and the information that have not been reported because it was of no perceived benefit internally or because they could not overcome problems caused by legacy systems, regulatory reporting requirements, lack of tools and experience, cost or risk
7. Whether it is possible to establish a generally accepted method for measuring changes in business reporting, so that managers, stakeholders, standard-setters, regulators and future reformers could better understand the effectiveness of regulatory and other mechanisms for bringing about change