Chapter 1

INTRODUCTION

- Introduction
- Nature of the Problem
- Review of Literature
- Objectives of the Study
- Research Methodology
- Plan of Work
Introduction

In the highly competitive global environment of today, more emphasis is given on the prospect and growth of an organization than just its present performance. Physical assets are increasingly occupying back seats as value drivers of an organization. Intangible assets like brand, patent, technical know-how and other types of intellectual property are fast becoming major value drivers. This fact can be corroborated if one takes a look at the market capitalization of some traditional giant organizations as compared to that of some brand- and knowledge-based organizations, the names of which were either not known or little known even a few years back. For example, in a recent study (Ghosh, 2000), it has been observed that the market value of Infosys Technologies, a software organization, was more than three times that of Hindustan Petroleum while the book value of the tangible assets of the latter was more than eleven times that of the former in the financial year 1998-99.

Thus, the value of a firm lies not in the bricks and mortars that it possesses but in its intellectual capital. The importance of intangible assets in the success and growth of a firm has also been confirmed by some captains of industries. A few examples are given below.

"If this business were to be split up, I would be glad to take the brands, and goodwill. You would have all the bricks and mortars and I would fare better than you." [John Stuart, former CEO, Quaker] (Ong, 1997)


"The BPL brand is valued higher than the plant and machinery on the company's balance sheet and even higher than all the capital employed by the company in the business." [Ajit Nambiar, former CEO, BPL] (Annual Report 98-99)

Thus, there has been a clear shift of emphasis from tangible assets to intangible assets.
Nature of the Problem
The traditional model of accounting nicely described the operations of companies for more than half a millennium. But it has been increasingly found unsuitable for measuring and reporting new kinds of assets, viz., intangibles that now play a crucial role in value creation and growth of companies. The traditional approach mainly focuses on the measurement and recognition of tangible assets. Thus, crediblity of financial statements of organizations, particularly brand- and knowledge- based organizations in which a substantial part of their value comprises intangibles, has begun to be questioned. Bill Gates once commented (Economics Times, 14.6.99) “Our primary assets, which are our software and software development skills, do not show up on the balance sheet at all. This is probably not very enlightening from an accounting point of view.” Arthur Leavitt, the then chairman of the Securities Exchange Commission (the stock market regulatory authority in the USA), remarked “We have long had a good idea of how to value manufacturing inventory or assess what a factory is worth. But today, the value of R&D invested in a software program or value of a user base of an internet shopping site is a lot harder to quantify. As intangibles continue to grow in both size and scope, more and more people are questioning whether the true value – and drivers of that value – is reflected in a timely manner in publicly available disclosure.” [Stewart, 2002,]. In the words of Judy Lewent, the chief financial officer of Merck & Co., “In a knowledge-based company, the accounting system doesn’t capture anything really.” (Edvinsson & Malone, 1997). In fact, at the dawn of the twenty-first century, a company, manufacturing or servicing, has to be knowledge-based for survival and growth.

No disclosure or inadequate disclosure of intangibles inevitably leads to a number of problems.

- Firstly, performance evaluation of an organization based on Return on Capital employed (ROCE), the widely used accounting ratio for such purpose, becomes unrealistic.
- Secondly, its investors are not in a position to know the actual worth and growth potential of their investment just from the balance sheet.
• Thirdly, its top management can not assess and monitor the intangibles – the investment in intangibles remains either unreported or almost unreported in the balance sheet.

In fact, disclosure of intangibles in an organization’s balance sheet is likely to put up a powerful defence against corporate predators and, thereby, can check the possible takeover bids. Also by disclosing the intangibles in the balance sheet, an organization can improve upon its Debt-Equity ratio and, thus, enhance its borrowing capacity at a relatively lower cost.

That balance sheet is not reflecting the intangible asset of the business is not just a theoretical problem. It is likely to have a serious adverse impact on the growth of the capital market and the economic development of a country. Investors as well as managers need to know about investment in intangible assets and return on those assets for optimum allocation of their funds. But under the existing system of financial reporting which keeps these information mostly hidden, investors remain in the dark and fail to understand where to make investment profitably. Managers also become largely responsible for corporate failure, as they have to operate by guesswork only. In fact, the managers should know which activities to encourage, what kinds of investment to make and what kinds to avoid for improving the overall profitability of the company. But poor knowledge about intangibles makes it harder for them to make cost-benefit analysis for a wider range of business activities.

The present study aims, *inter alia*, at discussing various conceptual issues relating to intangibles and the techniques for their measurement; determining the nature and extent of their disclosure in the balance sheet and outside the balance sheet; reviewing the relevant accounting standards, and taking a look at the global scene of the accounting practices.

**Review of Literature**

Extensive research works have been carried out in the industrially advanced countries, since the beginning of the last century, regarding the much discussed traditional
intangible, i.e., goodwill. The Master Valuation Account concept of goodwill was developed, which considered goodwill as the value of the business left to be allocated to any individual asset (Canning, 1929). Attempts were made to explore the nature of goodwill even in the early years (Leake, 1921; Yand, 1927; Kaner, 1937; Miller, 1973). Issues pertaining to different methods of disposal of goodwill have been examined in detail and problems relating to the recording of fake goodwill have been identified (Basu, 1969). Goodwill has been thought to represent the business phenomenon of synergism (Bedford, 1970). Goodwill has been described as an unidentified accounting object (Kohen, 1990). Goodwill has been considered as a generic term embracing many not-so-quantifiable attributes like business reputation, customer relation, strategic location, etc. (Tollington, 1997). The emerging trends in the accounting for purchased goodwill in some significant countries have been highlighted (Basu, 1998). Definitional issues, different theories and the methods of valuation and writing off relating to goodwill have been discussed and examined in detail (Verma, 2000). The investors' perception regarding the reporting of purchased goodwill and the relationship of amortization with a firm's market value have been examined in a recent study (Alshinifi, Maheshari and Borgla, 2001).

Major research works have also been carried out relating to measurement and accounting of human resources. A model of accounting for human assets, involving capitalisation of costs of recruitment, training, familiarisation and development, has been developed (Likert, 1967). A team guided by Likert and Pyle developed a system for R.G. Barry Corporation (USA) which was formally introduced in 1968. Different cost approaches like Historical Cost (R.G. Barry Corporation, 1968), Replacement Cost (Hekimian and Jones, 1967; Flamholtz, 1971), Opportunity Cost (Hekimian and Jones, 1967), Standard Cost, Current Purchasing Power, etc., have been developed. A number of present value approaches have also been developed, viz., Present Value of Future Earnings Model (Lev and Schwartz, 1971), Stochastic Rewards Valuation Model (Flamholtz, 1971), Economic Value Model on group basis (Jaggi and Lau, 1974), Adjusted Present Value Model (Hermanson, 1974), Unpurchased Goodwill Model, Human Asset Multiplier Model, Return on Effort Model, etc. Debates have been raised.
whether human resources can be assetised. A study was conducted in the USA to assess the usefulness of information relating to human resources to different user groups (Sangeladgi, 1975). Another useful survey of Human Resources Accounting (HRA) has also been made (Siegel, 1980). In India, attempt has been made to develop a Stochastic Process Model (on the basis of the models developed by Lev and Schwartz, 1971; Flammholtz, 1971; and Hermanson, 1974) for the purpose of valuation of human resources in the Hindustan Shipyard Ltd., Visakhapatnam (Rao, 1986). Some academicians have reviewed the literature on HRA and examined their relevance and current practices in India (Banerjee, 1981; Sinha, 1985; Banerjea, 1988; Gupta, 1988; Katiyar, 1992).

Some distinguishing features of intangibles have been identified and the need for accounting for intangibles has been stressed upon (Hendriksen and Breda, 1992). The importance of brand and different methods of measurement and accounting for brand have been examined (Kapferer, 1992). A new model of reporting Key Performance Indicators (KPIs), both financial and non-financial, compatible with the knowledge economy has been developed (Kaplan and Norton, 1992, 1996). Accounting for intangibles in the food and drinking industries in the UK has been studied (Ong, 1997). The objectives of accounting for intangibles and relevant concepts and issues relating to accounting for goodwill, brands, patents, royalty, trademarks and similar intangibles (like franchise, license, royalty agreement and customer and subscription lists) and deferred charges (including research and development costs, pre-operating costs, organizational costs and computer software costs) have been examined in much detail (Diamond and Nicolaisen, 1997).

The concept of intellectual capital, its classification and measurement techniques have been thoroughly discussed (Stewart, 1997). A method of preparation of Intellectual Capital Annual Report has been suggested (Edvinsson and Malone, 1997). Intangible Assets Score Sheet for evaluating market worthiness of a company has been prescribed (Sveiby, 1997). An endeavour has been made to provide frameworks as well as practical advice with respect to several aspects of innovation (Teece, 2000). New metrics, identifying value drivers, and their reporting have been suggested (Eccles and others,
Some of the major issues surrounding measurement, management and reporting of intangible assets have been recently discussed and reviewed (Lev, 2001; Reily and Schweih, 2001; Stewart, 2001). An extensive project on methodologies of reporting on the creation of value has been undertaken (the Canadian Institute of Chartered Accountants, 2000). The growing importance of intangibles as corporate assets and their global accounting practices have been highlighted (Flower, 2002; Stolowy and Lebas, 2002). The need for redefining intangible assets and the Exit Price Accounting Model for their recognition and measurement have been stressed (Basu, 2003). New business reporting models that have been developed over the last ten years or so in the context of growing importance of intangibles, have been analysed to illuminate the reasons for their limited success to date and a series of questions in this connection have been raised for further discussion and research (ICAEW, 2003, 2004).

The researcher has not so far come across any comprehensive published research work in India on the accounting for different types of intangibles in the Indian public limited companies other than a few works on goodwill only (Basu, 1969; Verma, 2000). And, that has prompted the researcher to make a modest attempt to study the accounting for intangibles that are fast becoming major value drivers in the corporate sector even in India.

Objectives of the Study

In research- and knowledge-based or brand-dependent organizations, intangible assets are more valuable than physical assets. But, the entire or substantial portion of intangible assets remains either unreported or almost unreported in the balance sheets of such organizations. But information regarding intangibles is very much required for appreciating an organization’s earning prospect and estimating its future cash flow. The Financial Accounting Standards Board [FASB] (USA), in its Concept Statement No 1, ‘Objectives of Financial Reporting by Business Enterprise’, issued in November 1978, stated that the purpose of financial statements is to provide investors and creditors with information about future earnings and cash flows.
Realizing the need for, and importance of, accounting for intangibles, the Accounting Standard Board (ASB) in the UK issued a Financial Reporting Standard (FRS) No.10 on goodwill and intangibles in December 1997. The International Accounting Standard Board (IASB) also issued the International Accounting Standard (IAS) No.38 on intangible assets from 1st July 1999. The standard has been further revised in March 2004 to ensure better accounting for intangibles. The FASB issued Statement of Financial Accounting Standard (SFAS) No.142 entitled ‘Goodwill and Other Intangible Assets’ w.e.f. December 15, 2001. It supersedes the Accounting Principle Board’s (APB) Opinion No.17, ‘Intangible Assets’. The Council of the Institute of Chartered Accountant of India (ICAI) has recently issued Accounting Standard (AS) 26, ‘Intangible Assets’, which has become mandatory from the accounting periods commencing on or after 1.4.2003 for enterprises whose equity or debt are listed on a recognised stock exchange in India and for enterprises whose turnover for the accounting period exceeds Rs.50 crores. In respect of all other enterprises, AS 26 has become mandatory from the accounting periods commencing on or after 1.4.2004.

In the backdrop of such developments, the present study makes an attempt
1) to examine different concepts of intangibles, and their classification, characteristics, measurement techniques and disclosure (Chapters 2 & 3);

2) to review the recommendations of different international and national standard-setting bodies regarding accounting and reporting of intangibles (Chapter 4);

3) to construct/present a global picture of accounting for intangibles (Chapter 5);

4) to find out the proportions of tangible and intangible assets in the value (in terms of market capitalization) of the large Indian public limited companies considered in the survey (Chapter 6);

5) to review the current practices of accounting for intangible assets in the companies considered in the survey (Chapter 6);
6) to examine the extent to which market capitalisation is related to profitability in case
of the companies surveyed (Chapter 6);

7) to consider whether the balance sheet of a company should be made to reflect its
market value in the Indian context (Chapter 7); and

8) to suggest measures for better accounting for intangibles, keeping the requirements
and expectations of various types of users of financial statements in mind, on the
basis of the theoretical appreciation of the issues involved and the empirical findings
(Chapter 7).

Research Methodology
The study is both explorative and empirical in nature.
The explorative part deals with the emergence of the knowledge economy, factors
driving intangibles and various conceptual issues relating to intangibles and their
measurement and reporting techniques. This part also discusses, in depth, some important
identifiable intangible assets like goodwill, brand, etc. Review of the accounting
standards issued in the major countries including India, along with that issued by the
International Accounting Standard Board (IASB), and their comparative analysis have
also been made in this part. This part has also not lost sight of the accounting practices
relating to intangible assets in the international arena. For this explorative part, the
researcher has drawn heavily on the available literature (i.e., articles, books, reports,
documents, etc.) in this field and the relevant accounting standards issued abroad and in
India by the standard-setting bodies.

For the purpose of the empirical study, i.e., examination of the current practices of
accounting for intangibles in the Indian companies, the researcher has relied on the
published annual reports of some selected Indian companies. The population of the study
comprises the top 50 companies ranked in terms of 'market capitalization' in a survey
conducted by the 'Economic Times' in March 2002 (ET 500, March 2002) [see Table 14,
The market capitalization in that survey was based on the average market price of shares during the period 1.2.2002 to 15.2.2002. The market capitalization has been considered as the basis of selection for the study because intangibles in a company are usually defined as the excess of the company's market value over the fair value of its tangible assets. Moreover, these companies very well represent the major industries in India. The period of survey covers 5 financial years, i.e., 1998-1999, 1999-2000, 2000-2001, 2001-2002 and 2002-03. 5 years seem to be a reasonable period for study, 2002-2003 being the latest one in terms of availability of annual reports.

According to the researcher, the selection of this period carries some sense because of the reasons given below.

- The concept of a knowledge economy has emerged towards the end of the twentieth century and since then the emphasis has largely shifted from physical assets to intangible assets.
- The wide divergence between the book value and the market value of firms, particularly the knowledge-and brand-based companies, has begun to appear towards the end of the twentieth century.

For the purpose of this study, those top 50 companies were requested to provide their annual reports for the above-mentioned accounting years. Altogether 30 companies finally responded by sending their annual reports for those accounting years. Thus, the effective sample has become 30 companies, representing 60% of the population [see Table 15, page-182].

In the empirical part, the researcher has studied the issues mentioned below with respect to the sample companies.

1) extent of intangibles in the entity values
2) extent of intangibles accounted for in the balance sheet
3) the types of intangibles capitalised in the balance sheet
4) reporting of intangible assets in the balance sheet
5) the Amortisation Policy followed regarding intangible assets
6) the degree of importance given to the disclosure of Accounting Policy regarding intangibles
7) whether intangibles are reported outside the balance sheet
8) whether there is any relationship between profitability and market capitalization
9) the impact on Debt/Equity ratio if the balance sheet is to reflect market value
10) the impact on Profitability ratio if intangibles are considered in the balance sheet

The relevant data available from the annual reports of the sample companies have been tabulated, processed and analysed, keeping the objectives of the study in mind. Based on such analysis, meaningful inferences have been drawn. The empirical findings of the survey have been presented, in detail, in Chapter - 6.

Plan of Work

The entire study has been divided into seven chapters as stated below.

Chapter-1: Introduction (Nature of the Problem, Review of Literature, Objectives of the Study, Research Methodology, and Plan of Work.)

Chapter-2: Intangibles — A Conceptual Discussion

Chapter-3: Some Important Intangibles — Concepts and Measurement Techniques

Chapter-4: Intangibles — The Accounting Standards

Chapter-5: Accounting for Intangibles — The Global Scene.

Chapter-6: Intangibles — A Survey of Accounting and Reporting Practices in India

Chapter-7: Conclusions and Suggestions