Chapter-3

Some Important Intangibles – Concepts and Measurement Techniques

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Goodwill

Introduction

Goodwill has long been and continues to be a highly debatable subject in accounting. Accountants as well as jurists have been deliberating on it for long but are yet to come to a meaningful conclusion as to its precise nature. It belongs to that twilight region where accounting abandons all its attempts to be a science. It is referred to as an unidentified accounting object analogous to UFO i.e., unidentified flying object usually seen in the sky (Cohen, 1990, p-28). However, although it has remained a mystery, it is very often required to be considered in the world of trade, industry and commerce. Its importance in business has been emphasised by using different connotations. It has been biologically described as the ‘sap’ and life of the business. Architecturally it has been described as the ‘cement’ binding together the business and its assets as a whole. It has been described in terms of magnet as the ‘attractive force’ that brings in customers. In terms of competitive dynamics goodwill has been described as the ‘differential return of profit’.

Nature of goodwill

Existence of goodwill in a firm enables it to earn more than the normal profit, which is supposed to be earned by a new firm in the industry. But goodwill has got no physical form. It is an intangible asset. In fact, it is the most intangible of intangibles. The uniqueness of goodwill is that it has got no separate existence. It can not be sold or purchased as an independent asset. Only along with the business it can be sold or exchanged. As goodwill can not be purchased or sold separately from business, Chambers, the noted accounting academician, was not in favour of recognising goodwill as an asset (Chambers, 1966). But exchangeability is an important but not the sole criterion of asset recognition.

There are several views on goodwill as developed by accounting academicians. The Master Valuation Account View as propounded by John Canning is noteworthy. According to this view, goodwill is not treated as an asset. It is simply considered as the
residual value of the firm that can not be associated with any tangible or identifiable intangible assets. This concept considers that the value of a firm arises out of contribution of all assets towards its cash flow. Its value should, therefore, be thought to consist of values of all assets. After assigning the value of the firm to each tangible and intangible asset, if anything is left, that is recorded as goodwill. The slice of the value of the firm to be assigned to an asset may be equal to its net realizable value in case of assets like land, machinery, patent, inventory etc. In case of receivables, values to be attributed to them may be equal to the present value of expected cash receipts. Whatever value remains unallocated is termed as goodwill. So more the assets are identified and assigned value, the less will be the goodwill residual. Accordingly, it has no meaning. It is purely and simply a plug not capable of deserving the status of an asset.

But it would be too drastic to deny goodwill its recognition as an asset. Like other assets, it also has future benefit potential.

The Hidden Asset View is another view of goodwill. In course of operation, a business develops various assets like good customer relation, good business connection, workforce with experience and high degree of loyalty, favourable location, outstanding sales, net work etc. The organisation derives substantial benefits from these assets. But these assets are not recognised on the balance sheet. Balance sheet recognition requires fulfilment of the objectivity criterion. These assets can not fulfil this criterion. They can not be objectively measured. According to some authorities, goodwill represents those hidden assets. Because of the hidden assets, the going concern value exceeds the sum of the values of assets recorded on the balance sheet. The excess value is attributed to goodwill.

The hidden assets view is, however, not above criticism. Many argue that these hidden assets may be attributed to some specific assets including other intangible assets. For example, the value of excellent reputation may attach to the value of brand names. A favourable location may mean that the value of land and building is more than similar land and building located elsewhere.

The Excess Profit View is the most popular view of goodwill. According to this view, goodwill represents the present value of expected future earnings in excess of what
is considered normal. The excess profit view, however, does not say much about the nature of goodwill. It actually deals with the measurement of the value of goodwill. To find out excess profit, it is first required to determine the future maintainable profit. The second stage involves ascertainment of normal profit that is supposed to be the reasonable return on invested capital. This invested capital is determined in terms of market value. Excess profit is the difference between future maintainable profit and the normal profit on invested capital. Then goodwill is determined by multiplying the excess profit with a chosen factor representing the number of years over which the excess profit is likely to be enjoyed.

According to this view, the value of goodwill is dependent upon the subjective assessment of future maintainable profit and to some extent the arbitrary selection of the number of years of purchase. Moreover the question that may arise is how far it is justified to assume that identifiable tangible and intangible assets can earn only a normal rate while other factors are responsible for excess profit. An asset may earn more than a normal rate of profit because of its efficient utilisation, increased demand for the product, market imperfection and so on. So any attempt to develop a concept of goodwill on the basis of capitalisation of superior earning is completely artificial (Hendriksen & Breda, 1992).

It appears that goodwill is still a nebulous concept in accounting. The available views on goodwill as offered by experts lack comprehensiveness and are subject to some or more limitations. A variety of factors are responsible for goodwill creation. And it is very difficult to make a generalisation about them. Examples of factors that lead to goodwill creation are:

a) favourable location
b) good customer relation,
c) efficient management team,
d) favourable Government regulation,
e) efficient and effective production process,
f) secret formulae,
g) customer databases,
h) software and information system,
i) good credit rating,
j) dedicated labour force,
k) reputation,
l) absence of competition,
m) supply contracts,
n) franchise,
o) advertisement campaign.

It is to be noted that the price offered for acquisition of a business over and above the fair value of its net assets might not represent goodwill of the business. A buyer may offer price for his own convenience like avoiding the time for setting up a new business, getting adjacent space etc. He may not even care whether or not old customers will return to the old place. In this case the excess price offered does not represent the value of goodwill in the true sense. Only when the excess price is offered for any one or more of the above-mentioned favourable factors, that excess price should be termed as goodwill. Again the existence of one or more favourable factors does not always result in goodwill. Goodwill depends upon the hard fact of superior profit earning. It may so happen that excess profit resulting from good customer relation or advantageous location is eaten up by inefficient administration or faulty spending. So goodwill is an umbrella concept embracing several favourable factors which enable a firm to earn profit at a rate higher than the rate of profit normally expected by a new firm in the industry. Factors contributing towards goodwill may differ from firm to firm. Again in a firm the favourable factors may change with the passage of time. Some factors may disappear and some new ones may appear.

From the above discussion, some distinguishing characteristics of goodwill can be identified as follows:

1) The value of goodwill has no reliable and predictable relationship to costs, which may have been incurred for its creation.

2) Individual factors that contribute towards goodwill cannot be valued.

3) The value of goodwill may fluctuate widely according to internal and external circumstances over a short period of time.
4) The goodwill is not consumed in the generation of earnings.

5) The assessment of goodwill is highly subjective.

Thus any value attributed to goodwill is unique to the valuer and to a specific point in time at which it is measured and is valid only at that time and in the circumstances prevailing then.

**Classification of goodwill**

Goodwill can be classified in different ways. While delivering judgement in the *Whiteman Smith Motor Co. vs. Chaplin* case, the learned judge zoologically classified goodwill as follows:

1. **Cat Goodwill**: Cat prefers its old home regardless of its actual owner. As such cat goodwill represents loyalty of customers who always go to old shops whoever keep it running.

2. **Dog Goodwill**: Dog is always faithful to its master and follows him wherever he goes. Similarly some customers have special attachment to some particular employees. Goodwill developed out of some personal attachment is called dog goodwill.

3. **Rat Goodwill**: Rat has no attachment and moves everywhere in search of food. Likewise some customers have no inclination to any particular shop and move from shop to shop in search of goods. So goodwill arising out of such customers is known as rat goodwill.

4. **Rabbit Goodwill**: Rabbit prefers to move around its hole and does not go further. Similarly some customers like to buy from nearby shops. So these shops receiving patronage of neighbouring customers enjoy rabbit goodwill.

According to Paton (1952, P. 488), goodwill represents value of the enterprise which may be attributed to the entire range of advantageous connections: Commercial, Industrial, Financial and Political. Accordingly goodwill can be classified as follows:
(a) **Commercial Goodwill**: It refers to the advantage enjoyed by the firm due to past efforts made like supply of quality goods and services at right prices and at the right time, timely fulfilment of commitment to suppliers etc.

(b) **Industrial Goodwill**: It arises out of factors advantageous to the growth of a particular industry. For example, TISCO enjoys industrial goodwill as it is situated in a region where all kinds of raw materials required for manufacture of steel are available at a cheaper rate.

(c) **Financial goodwill**: Financial goodwill represents financial and economic advantages enjoyed by a firm. For example, good credit rating, access to international capital market, enjoying lenders' confidence etc., indicate that the firm has a sound financial goodwill.

(d) **Political goodwill**: It refers to advantage enjoyed by the firm due to its affinity with Government and political parties. It may include special permit for import or export, tax concession, favourable attitude of politicians, etc.

(e) **Public goodwill**: It refers to good public image enjoyed by the firm. Good public relationship, community development programme etc. help the company acquire this goodwill.

Kaner (1937), another authority on the subject divided goodwill into seven categories:

(a) **Locality goodwill**: Business situated in a favourable locality enjoys such goodwill. For example, goodwill of a firm situated in a busy locality will definitely be more than that enjoyed by one situated at the outskirts of the city although they are of the same type and size.

(b) **Efficiency Goodwill**: Efficiency goodwill arises out of efficient management of all functions of the organisation namely innovation, design and development, production, sales, finance, administration, purchase etc. A firm enjoys greater efficiency goodwill if it produces quality goods and services according to changing requirements of society and with minimum resources and costs.

There are two kinds of efficiency – technological and economic. Technological efficiency means innovative ability of the firm. Well-established research and development activities with good technicians and scientists can result in innovative ideas
about products or services that are capable of meeting the changing requirements of society at the minimum cost. Economic efficiency means producing and selling goods or rendering services in the most economic way. When the firm ensures fullest customer satisfaction with overall efficiency and thereby generates higher profit, it is said to have efficiency goodwill.

(c) Establishment Goodwill: It is the natural tendency of customers to place greater reliance on an old firm than on a new firm. This is because they do not have previous knowledge about the ability of the new firm to cater to their requirements. So they become inclined to visit old and established firms to meet their needs. The goodwill enjoyed by a firm because of its long existence is called establishment goodwill.

(d) Organisational Goodwill: An enterprise with a sound, effective and efficient organisation is said to have organisational goodwill. A good organisation structure puts the concern in an advantageous position. It enables the firm to achieve its objective more efficiently and earn profit at a higher rate. An effective and efficient goodwill, therefore, enhances the organisational goodwill of the firm.

(e) Advertising Goodwill: Goodwill developed by advertising is called advertising goodwill. In the present competitive market, to get the product sold is a very tough job. Several firms produce and sell the same type of product or service with more or less the same quality and almost identical features. Under these circumstances advertisement plays a vital role. It makes the product known to the public, highlights the advantages of using the product, awakens the desire to buy the product, helps to create new market and keeps up steady demand. So firms now a days make huge investments in advertisement. If the advertisement is appealing, sales will increase and thereby profit will increase. In this way goodwill is generated and that goodwill is called advertising goodwill.

(f) Monopoly Goodwill: A firm with no competitor enjoys assured market for its product. So monopoly position results in a goodwill which is called monopoly goodwill.

(g) Personal Goodwill: Goodwill arising out of personal reputation of owners is called personal goodwill.
Kaner contends that each of these seven types of goodwill should be separately measured and valued. According to him, severe divergent and misleading results of valuation of goodwill arise because they are bundled into one and valued in a lot under the number of years’ purchase method or annuity method.

But Kaner’s proposition has been criticised by other authorities. Thus, Lall (1967) in an article said “…..I would suggest that such classification is absurd and more absurd would be a valuation made on the basis of any of the factors to the exclusion of others. The factors that make goodwill are apparently different in nature but really inter-dependent and inter-related, that it is impossible to evaluate the effect of any one of the factors in terms of monetary units. To cite but one example, cordial and healthy employer-employee relations will naturally be reflected in quality and price of the product and in turn, the attitude of the customers. The fact of the matter is that it is impossible to segregate the financial effect of specific factors”.

Regarding the classification of Kaner, Basu (1969) has mentioned in his research study that Kaner is found to associate goodwill with the cause of some benefit. He has opined that causes leading to the creation or happening of anything can not be the thing itself. Accordingly, it would be justified to equate goodwill not with causes but with benefits arising out of causes.

Despite of the contradictory views expressed by Dr. Lal and Dr. Basu, Kaner’s classification of goodwill will be of definite use for valuation of goodwill. If the causes responsible for goodwill creation are duly considered and given weightage on the basis of the degree in which they exist, the valuation would be more realistic.

**Internally Generated Goodwill vs. Purchased Goodwill**

A firm is not born with goodwill. Goodwill has to be either generated within the firm or purchased along with some existing business. But generation of goodwill within the firm is not automatic and instantaneous. It is developed over a period of time through constant effort and sacrifice. Apart from regular production, administration and sales, the firm is required to take various actions like community development, employee development, better liaison with customers, product development etc., which have favourable effects on
its reputation. Again goodwill, once generated, has to be nurtured, otherwise it will disappear. So these activities have to be continuously undertaken. All these activities involve costs. It is the well-established rule of accounting that a cost expected to benefit the organisation in future over a period of time should be capitalised and charged to the profit and loss account of different years according to the benefits derived in those years. On the other hand, costs whose benefits are restricted to the year of incurring are expensed in that year. Now in order to recognise the internally generated goodwill, it is necessary to segregate costs, which will have favourable effects on the future earnings from those which will expire within the year. But any such segregation will be arbitrary and without any basis. As accounting is based on the principle of objectivity and conservatism, accountants have preferred to expense away all goodwill generating costs in the year in which they are incurred. Thus, internally generated goodwill is not recognised in accounts.

The problem, which is encountered in case of internally generated goodwill, is not however faced in case of purchased goodwill. It has already been mentioned that purchased goodwill can not be purchased alone. It can be purchased only along with an existing business. When an existing business is purchased, some excess payment over the fair value of net assets taken over has to be paid for its superior profit earning capacity. Such excess payment is recorded as goodwill.

**Methods of Valuation of Goodwill**

Although goodwill is a nebulous concept in accounting, it is required to be valued by accountants for special purposes like valuation of shares, admission of partners, amalgamation of business etc. Some of the important methods of valuing goodwill are discussed below:

1. **Market based approached:** Under this approach, the market value of a firm is first ascertained based on equity capitalization. Equity capitalization is the product of the number of equity shares and the market value per share. From the market value of the firm thus ascertained, the fair value of net assets is deducted. Ascertainment of fair
value of net assets depends upon the nature of such assets. Non-monetary assets are generally valued on the basis of their replacement value. However, if an asset is not worth replacing, it should be valued based on its realisable value or deprival value. As a matter of fact, deprival value refers to the loss likely to be suffered by the firm if it is deprived of the opportunity of using the asset. On the other hand in case of monetary assets, the monetary amount involved is taken as the fair value of such assets. However if the monetary assets are supposed to be realised after a long period, their present value may be considered using an appropriate discount rate. So far as the liabilities are concerned, the monetary amount that is to be discharged is taken as the fair value. In most of the cases, the amount at which the liability is stated in the books is considered. However, in some cases, the fair value of a liability may differ from its book value. As for example, if the actual rate of interest of a bond is different from the prevailing market rate of interest, the fair value of the bond will differ from its book value.

But valuation of goodwill based on equity capitalization is a highly controversial issue. Firstly, market price of shares is not fully related to the present earning or future prospect of the business. Very often it is influenced by factors not related to the firm. Secondly, quoted market price of shares usually reflects price of marginal transaction. If the entire share capital were transacted in one lot, the price of shares would be surely different. Moreover a lot of subjectivism is involved in the determination of the fair value of assets and liabilities.

(2) **Average Maintainable Profit Method:** Under this method, the value of goodwill is ascertained by multiplying the average profit of the last few years by the number of years’ purchase. The profits of past years are however, duly adjusted for some special items. Thus, income not likely to recur will be deducted from and expenses, which are also not likely to continue, will be added back to the past profit. Similarly, if there is any non-trading income like interest on investment of surplus fund, that is eliminated from the past profit to arrive at trading profit. This is because non-trading income has nothing to do with goodwill.
The adjusted profit of past years thus ascertained is averaged to get maintainable profit. Normally simple arithmetic average is taken, but if there is increasing trend in profit earning, weighted average may be taken. It has to be carefully decided as to how many past years’ profit should be averaged to get a realistic idea of the prospective earning capacity of the firm. Larger the number of years taken for averaging, greater is the possibility of the figure being more reliable. Considering a length of time covering a full trade cycle is likely to give a realistic figure. The average maintainable profit is then multiplied by the number of years’ purchase. The resultant figure is considered as the value of goodwill. The number of years selected for multiplication is supposed to be the period over which the benefit of goodwill will be enjoyed.

The defects of this method are:

a) Past years’ profit earning can not be the guarantee of future profit.

b) Arbitrariness involved in the selection of past years for averaging and the number of years’ purchase for multiplying may vitiate the results.

c) No account is taken of the capital to be employed in the business.

d) No recognition is given to the existence of excess earnings.

However, this method is very common particularly in small businesses where more intricate methods are not understood by the parties and may not be any more accurate.

(3) **Capitalization of profit**: The principle upon which it is based is that goodwill can be sold or transferred, only along with the business. Therefore, instead of arriving at the value of goodwill independently and then adding it to the value of tangible and identifiable intangible assets to make up the total value of business, the reverse procedure may be adopted. The value of business as a whole may be calculated by a formula suggested and then the value of goodwill can be determined as the residual by deducting from the value of business, the fair value of net tangible and identifiable intangible assets.

The necessary steps to be followed under this method are:

a) Ascertain the average net profit, which is expected to be earned in the future.
b) Capitalise this net profit at the rate, which is considered as the normal rate of earning on the investment made in this type of industry under consideration.

c) Find out the value of net tangible and identifiable intangible assets.

d) Deduct the value as per (c) from the capitalised profit i.e., the value of the business as in (b) and the difference is goodwill.

The above procedure may be summed up in the following way:

$$ \text{Goodwill} = \left[ \frac{\text{Profit} \times 100}{\text{Normal rate of return}} \right] - \text{(value of net tangible and identifiable intangible assets)} $$

The main problem of this method is the difficulty in determination of the normal rate of return. There is no definite yardstick for this purpose.

(4) **Super Profit Method:** This is the most popular method of goodwill valuation. Super profit is the excess of actual profit over normal profit expected. It is a direct-pointer to goodwill value as it indicates the special business ability.

The valuation of goodwill under the super profit method involves the following steps:

1. Profits of the selected number of past years are to be considered.

2. Adjustments are to be made to the yearly profits for special items, which will cease to have effect or will come into effect after valuation. Thus income not likely to continue will be deducted and new income expected to be earned will be added. Similarly, expenses, which are not likely to continue, will be added back and additional expenses likely to be incurred henceforth will be deducted.

3. The adjusted profits are averaged to get maintainable profit. Normally simple average is taken. However if there is an increasing trend in profit, weighted average may be considered.

4. If there is any non-trading income, that is eliminated from maintainable profit to get maintainable trading profit.

5. Trading capital employed in the firm is ascertained. Trading capital employed normally means net assets i.e., fair value of trading assets minus current liabilities and provision. Thus trading capital employed includes long term liabilities like debenture
fund but excludes investment of surplus fund outside the business. As trading capital employed includes long-term loan, interest on such loan should be added back to profit to find out comparable profit.

(6) The trading capital employed to be considered may be either average capital employed or closing capital employed.

Some accountants prefer to consider closing capital employed in place of average capital employed as a matter of conservatism (Chakroborty, 1995).

(7) Thereafter, ‘Normal rate of return’ which an investor would expect to receive on his capital in this type of business is to be determined.

(8) Normal profit is then calculated by applying the normal rate of return to average or closing capital employed.

(9) The normal profit thus ascertained is deducted from maintainable trading profit to arrive at super profit.

(10) Finally, the possible number of years, over which the super profit is likely to be earned, is estimated and goodwill is calculated by multiplying that number of years with super profit.

Besides the above main-mentioned method, there are three variants of the super-profit method:

a) **Sliding Scale Valuation of Super-profit**: This method is based upon the theory that the higher the amount of super profit, the more difficult it would be to maintain. This is because a higher amount of super-profit will attract more competition and consequently the period of earning of super-profit will be shortened. So super-profit of the firm is divided into two or three equal divisions. Each of these divisions is multiplied by a different number of years’ purchase in descending order from the first division. The summation of this multiplied figure is taken as the value of goodwill.

Thus, suppose the super-profit is estimated to be Rs.15,000 which is divided into three equal divisions of Rs.5000 each and the number of years of purchase is fixed as 5, 4 and 3 respectively. The value of goodwill will be calculated as follows:

- First Rs.5000 at 5 years’ purchase = Rs.25000
- Second Rs.5000 at 4 years’ purchase = Rs.20000

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Third Rs.5000 at 3 years’ purchase = Rs.15000

Rs.60000

(b) Annuity method of super profit: Under this method, the present value of the future stream of super profit likely to be earned is summed up to arrive at the value of goodwill.

For example, average super profit per annum is say, Rs.10000. The rate of interest is 10% and goodwill is to be valued at 5 years’ purchase. As per Annuity Table the present value of rupee one at 10% interest for 5 years is Rs.3.79. So, the value of goodwill in this case is Rs. \((10000 \times 3.79) = Rs.37,900\).

As the annuity method considers the time value of money, it is considered superior to the other variants of the super-profit method.

(a) Capitalisation of super-profit method: Under this method, the yearly super profit is capitalised to find out the value of goodwill. Thus the value of goodwill is ascertained as below:

\[
\text{Goodwill} = \frac{\text{Annual Super-profit} \times 100}{\text{Normal rate of return}}
\]

But the super profit method of goodwill valuation has some serious limitations. Firstly, the computation of future maintainable profit is a difficult process. It is based on many presumptions and assumptions and hence non-verifiable. Secondly, computation of capital employed is a controversial issue. The problems involved here are: (a) how to value tangible assets i.e., whether realisable value or deprival value or replacement value should be considered; whatever method is chosen, that is not supported by documentary evidence, (b) what should be the capital employed i.e., whether it means total value of assets without deducting liabilities or total value of assets minus current liabilities or total value of assets minus all outside liabilities; (c) whether average capital employed or closing capital employed will be considered.

Thirdly, normal rate of return is usually defined as the rate of return expected by investors on their investment. What is normally expected can not be objectively determined. Very often average of rates earned by firms in the industry is taken as the usual rate. But that is not necessarily an appropriate normal rate because of possible...
barriers to entry into an industry and because of obstacles to easy exit from the industry.

Fourthly, there is no general rule regarding the number of years’ purchase to be applied. It is selected arbitrarily. Lastly, this method does not consider the risk element. There is a great deal of risk in the earning power of the business in future in the highly competitive, uncertain and fast changing environment. So the value of goodwill ascertained under the super-profit method may not be very realistic.

**Accounting for Purchased Goodwill**

After recognition of purchased goodwill in accounts, the question that arises is what should be done with it. The following alternatives are available:

- Purchased goodwill is written off against ownership equity at the time of acquisition.
- Purchased goodwill is fully charged to the profit and loss account in the year of acquisition.
- Purchased goodwill is capitalised and amortised over its useful economic life.
- Purchased goodwill is capitalised and amortised over a specific period of time.
- Purchased goodwill is capitalised and it is then subjected to periodic impairment test.
- Purchased goodwill is capitalised and retained as a permanent asset.

Between the first two alternatives – immediate writing off against reserve or owner’s equity and write off against the profit and loss account, the former is a preferred treatment, as it does not distort the current year’s profit. The immediate writing off is justified for more than one reason. Firstly, it ensures consistency of treatment between internally generated goodwill and purchased goodwill. It is argued by many that since internally generated goodwill is not recognised in accounts, purchased goodwill should be eliminated from accounts instantly. Secondly, many have the notion that goodwill is an asset of doubtful character. So if financial statements are to maintain their credibility, they must get rid of this kind of soft asset. Thirdly, if goodwill is written off immediately
after its recognition, the future profit of the company will be relieved of bearing the
burden of amortisation. In fact, if the profitability is understated artificially, there may be
an adverse impact on the market value of the firm. This is because market is interested
only in the bottomline of the firm and not how it has been arrived at. Fourthly, immediate
writing off of goodwill spares the company of the decision regarding the period of
amortisation. There is no denying the fact that a great deal of subjectivity is involved in
determining the suitable period over which the goodwill is to be amortised and the
method by which it is to be amortised.

However instant writing off is not above criticism. Firstly, it ignores the economic
reality of goodwill. That goodwill has a significant bearing on the profitability of the firm
is ignored here. Secondly, if the amount of goodwill is substantial, the reserve may not be
sufficient to wipe it off. This possibility is very much there in the case of a knowledge-
based company where intangible assets are far more valuable than tangible assets.
Thirdly, as this method erodes the net worth of the firm, the debt-equity ratio tends to be
very high. Consequently the cost of borrowing increases. Fourthly immediate writing off
is contrary to the matching principle. As goodwill refers to the amount paid for super
profit likely to be earned in future, it should be amortized gradually over a period so that
there is matching of amortisation with super profit.

Deferral of goodwill and its gradual amortization however involves several problems.
Firstly, the period over which amortization will be done is to be selected. Generally
amortisation is done over the period during which the benefit of goodwill is supposed to
flow to the business. But it is next to impossible to assess objectively the period over
which the benefit of goodwill will flow. Any selection of period for amortization will be
arbitrary. That is why different standard setters have prescribed different time limits for
the purpose of amortization. For example, the UK accounting standard FRS-10 has
prescribed amortization of goodwill over its useful life subject to a refutable assumption
that its life does not exceed 20 years. According to the Japanese GAAP, purchased
goodwill is to be amortised within a reasonable period, which should not normally exceed
5 years. The Indian GAAP AS-14 has considered it appropriate to amortise goodwill
over a period not exceeding 5 years unless a somewhat longer period can be justified.
The selection of the method of amortisation is also a key issue of the deferral policy of goodwill. Usually the method to be used for amortisation should reflect the pattern of benefits likely to be flowing from goodwill. But in most of the cases that pattern can not be determined reliably. So the normal tendency is to follow the straight-line method of amortisation.

Amortisation of goodwill through the profit and loss account is also not always favoured. The critics of amortisation say that it leads to double charging the profit and loss account. It is argued that a company is constantly incurring expenses towards training, advertisement, promotion etc. These expenses which are instantly charged to the profit and loss account help to create and maintain goodwill. Now if capitalised goodwill is amortised, the profit and loss account is required to accommodate the double charge.

The other alternative i.e., capitalization and subjecting to periodic impairment test is not without criticism. Periodic impairment test is done to see whether the carrying value of goodwill is matching with its recoverable amount. The recoverable amount is defined as the higher of the net realisable value and the value in use. If the carrying value happens to be lower than the recoverable value, the amount of goodwill is said to have been impaired. The amount of goodwill thus impaired is charged to the profit and loss account. But impairment review is much more problematic. It involves calculation of net realisable value of the asset and, of its value in use. The question of net realisable value of goodwill does not arise, as it can not be sold separately. The calculation of the value in use requires identification of the future cash flow from goodwill. The estimated future stream of cash flows from goodwill is restated at present value by using an appropriate discount rate. The present value of future cash flows from goodwill, known as the use value of goodwill, is compared with its carrying value for impairment review. The whole process is much more oblique. Moreover there may be much volatility in reported earnings because impairment losses are likely to occur irregularly and in varying amounts. The immediate writing off of goodwill can relieve the company of this botheration.

Many accountants are in favour of keeping the goodwill as permanent asset as long as the earning is sufficient. It is argued that as purchased goodwill is being used up, it is
constantly being replaced by internally generated goodwill. So the total amount of goodwill of a firm remains unimpaired. That is why it is argued that there is no need to amortise purchased goodwill. However allowing goodwill as a permanent asset in the balance sheet may encourage corporate predation as the own earning of predators will not be diluted by amortization.

Negative goodwill
If the acquisition price of a business is less than the sum total of fair values of net assets (total assets minus total liabilities) taken over, the difference is known as negative goodwill. Theoretically negative goodwill is not supposed to arise. This is because, if the acquisition price happens to be less than the aggregate price of net assets, the owner of the company will be better off in selling all assets and meeting all liabilities separately instead of selling the business as a going concern. However, if the owner has poor negotiation skill or if he has to sell the business under any political compulsion or for any other reason beyond his control, the purchase price may be less than the fair value of net assets taken over.

Divergent accounting practices are in vogue regarding negative goodwill. For example, negative goodwill arising on acquisition of business is to be transferred to the Capital Reserve Account as per the Indian Accounting Standard AS-14. The British standard FRS-10 states that negative goodwill is to be disclosed in the intangible fixed asset category directly under positive goodwill. Then to the extent of fair values of the non-monetary assets taken over, it should be recognised in the profit and loss account in the periods in which the non-monetary assets are recovered, whether through sale or depreciation. Any excess of negative goodwill over the fair value of the non-monetary assets acquired should be recognised in the profit and loss account in the period expected to be benefited. The stipulation of FRS-10 has been criticised for more than one reason. Firstly, release of negative goodwill against recovery of non-monetary assets is problematic. Further, the stipulation of crediting excess of negative goodwill over the fair values of non-monetary assets to the profit and loss account during the period expected to be benefited is meaningless. In fact no period can be benefited from the existence of negative goodwill (Paterson, Accountancy, Feb., 1998).
As per the US GAAP, SFAS-141, Business Combination, if negative goodwill arises on the acquisition of business, the values of acquired assets except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale or otherwise and assets of a discontinued operating segment; (c) deferred tax assets, (d) prepaid pension assets and (e) other current assets, are to be reduced proportionately by the amount of negative goodwill. If any negative goodwill remains after this allocation, the excess should be recognised as an extraordinary gain in the period of acquisition.

The approach of the International Accounting Standard Board (IAS 22) towards accounting for negative goodwill is again entirely different. According to this standard, the portion of negative goodwill, which relates to future losses and expenses foreseen at the time of acquisition should be recognised as income when such future losses and expenses are incurred. However, two conditions must be fulfilled for this treatment. Firstly, the future losses and expenses can be measured reliably and secondly they must not represent identifiable liabilities at the date of acquisition. To the extent it does not relate to identifiable expected future losses and expenses or the expected or planned losses do not occur, the negative goodwill not exceeding the fair values of non-monetary assets acquired is recognised as income on a systematic basis over the remaining weighted average useful life of the acquired depreciable assets. Negative goodwill in excess of the fair values of the non-monetary assets acquired should be recognised as income immediately. Again IFRS 3 which has been introduced by IASB replacing IAS 22 in March 2004 requires that negative goodwill, if it arises, should be immediately recognised in the Income Statement as gain.
BRAND ACCOUNTING

Concept

In the recent years the value of brand as a corporate asset is being increasingly recognised by analysts and fund managers. However, a little bit of ambiguity still persists about its actual concept. Words such as ‘values’, identity, ‘image’ etc. are very often used to refer to it. Undoubtedly, brand embraces all these things. The American Marketing Association defines a brand as “a name, term, sign, symbol or design or a combination of them, intended to identify the goods or services of one seller or group of sellers and to differentiate them from those of competitors”. In essence, brand identifies the seller or maker. It should be noted that in a broader sense a trademark or logo can not be just the brand. Trademark or logo is only a subset of the broader concept of brand. The concept of brand is generally used with a meaning that is significantly different from and wider than a trade name. While every recognised brand has a trade name, the trade name is not synonymous with brand. Brand is perceived as displaying certain characteristics the effect of which is to help generate enhanced future earnings if managed properly. These characteristics are:

A recognised name
A product or range of products
An established operation and market position
Marketing and other specialist know-how
Trading connection

A brand is essentially a seller’s promise to consistently deliver a specific set of features, benefits and services to the buyers. It conveys a warranty of quality that the customers can take for granted. For example, while purchasing a TATA product, a customer can reasonably be assured about its quality. This quality assurance offered by this brand helps to avoid the risk associated with an unbranded product. Most customers are risk-averse and avoid the unknown. It is the branded product that offers them security and reduce worry and fear. Moreover if a branded product fails to live up to the expected level of quality, the buyer has recourse to the manufacturer.

By offering quality assurance and reducing risks, brand simplifies the purchasing decisions. It helps the purchaser to arrive at the purchasing decision quickly. This aspect
is particularly important at the time of buying a technical product all the specifications of which are not always understood. Furthermore, when products of various manufacturers are technically indistinguishable, it is the brand name that provides comfort and simplicity.

A powerful brand enables a firm to ensure sustainable growth even in adverse economic conditions. For instance, in 2001-02 while most of the Software companies in India failed to register growth due to worldwide economic turmoil resulting from the attack on the World Trade Center of the USA on 11th September, Infosys Technologies recorded a 21 per cent growth. This is because of the high esteem enjoyed by the Infosys brand in the Software sector (The Economic Times, 29th April 2002). A strong brand also enjoys longevity. It ensures corporate immortality if nurtured properly. A strong brand can also cut across national boundaries and culture with ease. Coca-Cola, for instance, has its presence in virtually every country in the world. It enjoys the same degree of emotional response all over the world. Moreover it is said that when a firm has a powerful brand, synergy is achieved. This is because the firm can simultaneously use the image generated by the existing brand in promoting a new product or service with little or no additional promotional costs.

In the present market economy, an increasing number of products and services are virtually becoming indistinguishable from one other. Under these circumstances the survival of a product depends upon its ability to break out of parity. A powerful brand name can only make this possible. It infuses value in the customer's perception of the product and thereby helps the product to stand out from the crowd and command a premium price.

The image of a strong brand is also a powerful motivator for the employees. It boosts up the morale and loyalty of employees and attracts quality staff. Efficient and ambitious executives always aim to work for the top brand because of the experience they are likely to gather.

The creation of a powerful brand for its product/service is, therefore, the aim of today's organisation. It provides a long term security and growth, higher sustainable profit and increased asset value of the firm by achieving for it:
competitive differentiation
premium prices
higher sales volume
economies of scale and reduced costs
greater security of demand

Very often no distinction is made between brand and goodwill. But they are not the same things. Goodwill consists of intangible assets that can not be identified separately and hence can not be sold without disposing of the business. For example, intangibles such as advantageous business relationship, better management, favourable government regulation etc., can not be sold, as they can not be separately identified from the business. On the other hand brand is an identifiable intangible asset of the company. It can be purchased and sold like any physical asset. For example, Hindustan Lever acquired the Lakme brand from the Lakme company for a consideration of Rs.110 crore (The Economic Times, 28th Dec., 1998); Smithkline Beecham acquired the Viva and Moltova brands from Jagagit Industries for Rs. 86.25 crore (The Statesman, 9th Feb.2000). Very recently Morpen Laboratories acquired Lemolate, a cough and cold brand, for Rs.11 crore from Yash Pharma Laboratories (The Economic Times, 26th June 2002). But goodwill can not be traded in this way.

The ten top brands in India according to a survey as reported in The Economic Times dated 14th August 2002 are as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>Dettol</td>
<td>1</td>
<td>8</td>
<td>Coca-Cola</td>
<td>6</td>
</tr>
<tr>
<td>13</td>
<td>Britannia</td>
<td>2</td>
<td>12</td>
<td>Pepsodent</td>
<td>7</td>
</tr>
<tr>
<td>2</td>
<td>Colgate</td>
<td>3</td>
<td>11</td>
<td>Pond's</td>
<td>8</td>
</tr>
<tr>
<td>-</td>
<td>Tata Salt</td>
<td>4</td>
<td>9</td>
<td>Pepsi</td>
<td>9</td>
</tr>
<tr>
<td>1</td>
<td>Lux</td>
<td>5</td>
<td>4</td>
<td>Thumps Up</td>
<td>10</td>
</tr>
</tbody>
</table>

The ten top brands in India according to a survey as reported in The Economic Times dated 14th August 2002 are as follows:
The ten most valuable global brands in the year 2000 as measured by Interbrand are as follows:

<table>
<thead>
<tr>
<th>Rank</th>
<th>Brand name</th>
<th>Value ($ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Coca-Cola</td>
<td>72.5</td>
</tr>
<tr>
<td>2</td>
<td>Microsoft</td>
<td>70.2</td>
</tr>
<tr>
<td>3</td>
<td>IBM</td>
<td>53.2</td>
</tr>
<tr>
<td>4</td>
<td>Intel</td>
<td>39.0</td>
</tr>
<tr>
<td>5</td>
<td>Nokia</td>
<td>38.5</td>
</tr>
<tr>
<td>6</td>
<td>General Electric</td>
<td>38.1</td>
</tr>
<tr>
<td>7</td>
<td>Ford</td>
<td>36.4</td>
</tr>
<tr>
<td>8</td>
<td>Disney</td>
<td>33.6</td>
</tr>
<tr>
<td>9</td>
<td>McDonald</td>
<td>27.9</td>
</tr>
<tr>
<td>10</td>
<td>AT&amp;T</td>
<td>25.5</td>
</tr>
</tbody>
</table>

Source: Global Financial Reporting, John Flower, 2002

These brands have been playing a significant role in increasing the competitive strength and ensuring the sustainable growth of the companies. That is why brand is considered as one of the important assets of the company.

WHY BRAND ACCOUNTING IS NECESSARY

The necessity of brand accounting has arisen because of the recent spate of brand transfer. It is transferred either along with the business or separately. The transferee then starts enjoying the benefits flowing out of the brand. So it is quite natural for the transferor to attach value to this asset and take the same as consideration against such transfer. After acquiring the brand the company has three options with its value. Firstly it can be written off instantly against reserve or current year’s profit. But very often brand represents one of the most valuable assets of the company. For example, in 1993 in the account of Guiness, a UK firm, the acquired brand of £1395m represented 36% of its total fixed assets of £4559m (Elliot & Elliot, 1997, p.577). So immediate writing off
will lead to a drastic depletion of shareholders’ fund. The debt-equity ratio of the firm will increase considerably thereby exposing the firm to a higher degree of financial risk. Moreover this policy is likely to cause an anomaly in another area. Acquisition of a powerful brand is likely to increase the market value of a firm. So, while the market value of the firm actually increases, its book value will decrease. The shareholders will be misinformed about the real worth of their shares and they might take the inefficient decision of disposing of them.

The second option of accounting for brand is to capitalise its acquisition costs and amortise it over a pre-determined period. For instance, the Hindustan Lever has decided to amortise the cost of the Lakme brand acquired from Lakme Company over a period of 5 years. But many brands actually have indefinite periods of life. In a study the Boston Consulting Group has seen that 19 of the 22 leading brands in 1925 were also the leading brands in 1985 (PI & Balakrishnan, The Chartered Accountant, January, 1999). So selection of any predetermined period for amortisation of brand will be less than justified. That is why many British companies such as Rank Hovis Mcdougall, Grand Metropolitan, Guinnes etc. (Ref Elliot & Elliot, 1997) have preferred to retain the brands at cost in the balance sheet unless there is permanent diminution in value. So this is the third option of brand accounting.

The issue of accounting for homegrown brand has emerged as a consequence of accounting for purchased brand. As an organisation has to incur a substantial amount of marketing expenditure for creating and maintaining brand, this expenditure has effect not only on current sales but also on future sales. Thus some types of marketing expenditure have the attribute of capital expenditure. But because of the difficulty of separating the marketing costs having effect on future sales and also because of the uncertainty attached thereto, the general practice is to write off all the marketing expenses in the year in which they are incurred. So, our quasi capital expenditure gets converted into revenue expenditure and reduces the current year’s profit. Accordingly homegrown brand remains ignored in our accounts. But accountants are often to be blamed for becoming rigid in case of such assets. Although most of the capital projects involve uncertainty, with the help of established guidelines and well-practiced systems, the costs and benefits of these projects are quantified. Costs of these projects are, therefore, capitalised.
is, therefore, no reason for treating the marketing expenditure in a different manner, specially when their implications are no less profound.

The policy of keeping homegrown brands outside the balance sheet is criticised for another reasons also. It penalises those businesses that have grown their brands organically by compelling them to show lesser asset values than those which have spent money on acquiring brands from outside. In fact both homegrown brands and purchased brands are valuable assets to the business and both should be, as opined by many experts, reflected in the balance sheet.

Keeping homegrown brands outside the balance sheet is also likely to hinder the stewardship function of management. If the investment made towards brand creation is shown as an asset in the balance sheet, it serves as a reminder to the management of the investment behind that asset. They will keep in mind their responsibility for earning reasonable return on it. But if this asset is not recognised in the balance sheet, the management will not have any urge to earn any return on this hidden asset.

Because of the above reasons there is growing support for valuation of homegrown brands. However, as it involves a great deal of subjectivity, many are in favour of disclosing their values by way of notes to the accounts. They argue that such information should be made available to the management and not be extended to the financial accounts. A survey carried out in 1990 by Interbrand, a brand consultant, among UK finance directors has revealed this fact (Accountancy, January 1990). But Martin Moorhouse, the group chief accountant of Ranks Havis Mcdougall, which for the first time in the world recognised homegrown brand in its balance sheet of 1988, described this policy as worse than dangerous (Accountancy, July 1990). He questioned – “What is the point of telling the chairman that he has made the management accounting profit when he has to explain a loss to the shareholders? Many management decisions are based on various strategies having impact on the financial accounts because it is the financial accounts that communicate performance to the market place”. Thus accounting for homegrown brand remains a controversial issue.

In my humble opinion, homegrown brands should be treated at par with purchased brands. As a conservative policy it may be disclosed by way of a footnote for a few years. But the possibility of excess profits arising out of such homegrown brands should
be noted over a period of two or three years and then if the result is positive the brand should be shown in the balance sheet as a valuable asset in the same way as a purchased brand.

VALUATION OF BRANDS

Whether for sale or for showing in the balance sheet or for disclosing as additional information in the annual report, brands need to be valued. Many analysts are now valuing reputed brands of the world on their own. For example, Interbrand, a brand consultant, published in July 2000 the Billion Dollar Brand League Table identifying 75 such names the first ten of which are listed in the Table 10 with their respective values. In India also some technology companies have started valuing their brand names. Infosys Technologies reported the value of its brand at Rs.5376 crores in its annual report 2000-2001. Satyam Computer another reputed Software Company of the country reported the value of its brand at Rs.2275 in the same year.

As brand has become one of the most important assets of the company, there has been a growing demand on the part of the users of the annual reports to publish more information on brand values. ‘The Case for Brand Value Reporting’ a report of Brand Finance of the UK in 2000, revealed that 73% of analysts questioned would like brand values to be disclosed in the annual report. This compares with 53% of analysts in Brand Finance’s first study back in 1997. In comparison with the growing demand for more information on brand values, Brand Finance claims that in practice only six of the 350 companies surveyed reported brand values in their balance sheet. It concludes that supply has yet to meet the demand (Goodchild and Callow, 2001).

But in determining the value of the brand one has to face several difficulties. These difficulties arise from the very concept of value. Value is not a unique concept. It may mean several things depending upon the perception of the person who makes the valuation. So a lot of subjectivity is involved in the process. The various approaches to valuation of brand are discussed as follows:
1. Historical Cost Approach

Brand is an asset that is developed by constant effort of marketing and advertising over a period of time. So the sum total of marketing and advertising costs incurred for developing a brand may be taken as value of the same. With a well-established system of accounting, these costs which were included in the past income statement can be determined objectively. So this approach to valuation of brand appears to be simple and logical. Nevertheless it presents the following practical difficulties:

a) Most of the brands are very old, as it has been indicated earlier. So question arises as to the period over which costs should be taken into account. Moreover the realistic approach would be to determine to what extent the present market share relates to past advertising. This is in fact a very difficult task.

b) Advertising investment has a double marketing purpose. One purpose is to ensure extra sales during the current period while the other purpose is to create brand awareness and image. It is practically impossible to split year by year the costs contributing to these separate results of advertisement.

c) Behind creation of a powerful brand, besides cash outlay other factors namely stringent quality control, accumulated know-how, specific expertise, personal involvement etc. also play a significant role.

d) It is not simply the question of adding up costs. An appropriate discount rate has to be chosen to restate them at present value.

e) The cost approach to valuation would not apply to brands such as Rolls Royce or Mercedes that rely much on reputation. It can also be said that past expenditure can not be a guarantee of present value. Several heavily advertised brands are hardly recognised in the market now. It is, therefore, noted that the cost approach to valuation requires several assumptions and has also some practical difficulties.
2. Replacement Cost / Current Cost Approach

Under this approach, valuation is done based on estimated costs likely to be incurred for recreating a brand similar to the one in question. Keeping in mind the total profile of an existing brand namely awareness, relative market share, image and leadership, estimate of total costs is made for creating a similar brand. But the question of recreation of certain brands does not arise. For example can one remake Coca-Cola or Rolls Royce? Certainly not. These brands were borne in an era when advertisement costs were negligible. They were nurtured by reputation. Moreover to create similar brands the existing brands are to be displaced. There is no reason why today’s well known brands will allow themselves to be thrown out to give place to new brands. It is also not easy to imitate the performance level of brand leaders. Backed by research and development and know-how they enjoy competitive advantage, which gives them stability. Unless one has requisite technology it is not possible to recreate similar brands. Moreover the estimated costs of recreating a brand may be more or less than its economic value. Actually value of anything depends upon its output and not on the inputs.

3. Market Based Approach

Under this approach valuation of a brand is done based on the transaction of similar brands in the market. This approach to valuation raises two major problems. The first one is that a market does not effectively exist for brands. Brand transactions are relatively few and far between. Secondly, while acquiring a brand each purchaser makes his own valuation based on his own view and strategy. Why did Coca-Cola pay Rs.110 crores to Parle Company for the Thums-up brand? It resulted from the pressing need on the part of Coca-Cola to enter into the Indian market from which it was absent for a long period.

The price paid for a similar brand is not, therefore, the true indicator of brand value. Moreover, it may so happen that a significant part of the price is for realizing some specific aim of the purchaser in question. Each purchaser has his own intention and framework of ideas. Proxy can not determine value. Furthermore, the published price may not be always the real price. Very often non-cash consideration or deferred payment is kept secret.
VALUATION ACCORDING TO POTENTIAL EARNING

Under this approach valuation of a brand is done according to the prospective earning from it. So excess earning directly attributable to brand power is required to be isolated. There are several methods of valuation according to potential earning.

a) The Premium Pricing Method
Under this method the difference between the price of a branded product and that of an unbranded product is first found out. The same is then multiplied by the brand’s volume of sales to obtain the amount that is taken as the value of the brand. In this method it is assumed that costs of branded and unbranded products are identical and their sales volume are equal.

The problem with this model lies in its hypothetical nature. There is no guarantee of the existence of an unbranded product with which to compare.

b) The Royalty Method
Under this method the expected royalties likely to be earned by transferring the right to use the brand is taken as the value of the brand. The future stream of royalty is restated at present value. The problem with this method is to select the appropriate discount rate and the time period. Moreover, the royalty figure may not solely include the price for use of brand. The owner may also undertake to supply a package of basic raw materials, know how, and services which enable the licensee to maintain the appropriate quality of brand.

c) Discounted Cash flow Method
It is the classic approach to evaluating any investment proposal whether material or intangible. The analyst estimates the net cash flow likely to be generated out of a brand over a period of time, say, five, eight or ten years. This is restated at present value using an appropriate discount rate keeping in mind the strength of the brand. Beyond the selected period, residual value is estimated based on perpetual income assuming that such income remains constant or increases at a constant rate.

Thus we have the formula:
Brand Value = \sum_{t=1}^{N} \frac{RB_t}{(1+r)^t} + \frac{Residual Value}{(1+r)^N}

RB_t = Anticipated revenue in year t attributable to the brand.

\( r \) = Discount rate

This methodology is faced with three problems namely, estimation of the future cash flow, choice of the period and selection of the discount rate. The prediction of cash flow will be ruined if the competitor launches a superior product. The subjectivity involved in the selection of the discount rate also questions the validity of this method. Finally criticism is also levelled against the choice of the period for calculating cash flow, that is why ten years and not fifteen or twenty years?

**The multiple method**

The brand multiple that is propounded by Interbrand can also be used in determining the value of a brand. This is analogous to the price-earning (P/E) ratio that links the value of equity with net profit. A high P/E ratio indicates investors' confidence in a firm's earning potential. Similarly brand multiple correlates brand profit with brand value. This approach to valuation involves the following four stages:

1. Determination of the weighted average of the last three years' post tax earnings generated by the brand.
2. Assessment of brand strength based on the scoring of the brand against a set of seven factors such as—
   - Leadership: Is the brand a market leader?
   - Stability: Is the brand long established with customer loyalty?
   - Market: Is the brand's market stable?
   - Internationality: Is the brand national or international?
   - Trend: What are the long term and short term trends of the brand?
   - Support: How much investment and support has the brand received?
   - Legal Protection: Is the brand legally protected (e.g., Registered Trademark)?
The following example will clarify/explain how brand strength is determined:

**Table 11**

**Evaluation of Brand Strength**

<table>
<thead>
<tr>
<th>Evaluation factor</th>
<th>Full Score</th>
<th>Brand A</th>
<th>Brand B</th>
<th>Brand C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leadership</td>
<td>25</td>
<td>19</td>
<td>19</td>
<td>10</td>
</tr>
<tr>
<td>Stability</td>
<td>15</td>
<td>12</td>
<td>9</td>
<td>7</td>
</tr>
<tr>
<td>Market</td>
<td>10</td>
<td>7</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Internationality</td>
<td>25</td>
<td>18</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>Trend</td>
<td>10</td>
<td>7</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Support</td>
<td>10</td>
<td>8</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Protection</td>
<td>5</td>
<td>5</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Brand strength</td>
<td>100</td>
<td>76</td>
<td>54</td>
<td>46</td>
</tr>
</tbody>
</table>

*Source: Strategic Brand Management by Jean Noel Kapferer, 1995, pg. 203.*

3. Deciding the Multiple. Interbrand has developed a chart known as the “S-Curve” linking the multiple with brand strength. Based on the empirical examination of the multiple in actual brand transactions over a period of time, this “S-Curve” is developed. Then by fitting the actual score of the brand in the curve, the multiple of the home grown brand is identified.

The S Curve linking brand strength with brand multiple is as follows:
In the early stage of the life cycle, the increase in the value of brand is gradual. As the brand establishes itself, the growth is exponential. Then in the latter stage, its growth rate declines.

1. Deciding the brand value. This is calculated by multiplying the weighted average brand profit with the relevant brand multiple.

The greatest advantage of this approach to brand valuation is that it is based on hard facts in as much as actual brand profits over the last three years and multiples based on recent deals in the similar field are considered.

However, this approach is criticised as the determination of brand strength involves a great deal of subjectivity. Moreover the possibility of overbid in actual transaction cannot be ruled out. Even if there is no overbid, a buyer measures the value of a brand according to his own vision, strategy and expected synergies. So, it may not be logical to value a brand based on multiples coming from market transaction.
It is, therefore, being noted that each method of valuation of brand has its merits and demerits. No method is suitable in all circumstances. A survey conducted by Interbrand (1990) among UK finance directors revealed the degree of support enjoyed by each method of valuation as follows:

Table 12

Percentage of Support Enjoyed by Different Methods of Band Valuation

<table>
<thead>
<tr>
<th>Method of Valuation</th>
<th>Percentage of Support</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value</td>
<td>26%</td>
</tr>
<tr>
<td>Historical cost</td>
<td>19%</td>
</tr>
<tr>
<td>Discounted Cashflow</td>
<td>17%</td>
</tr>
<tr>
<td>Multiple Method</td>
<td>10%</td>
</tr>
<tr>
<td>Replacement / Current cost</td>
<td>7%</td>
</tr>
<tr>
<td>Premium pricing</td>
<td>5%</td>
</tr>
<tr>
<td>Others</td>
<td>10%</td>
</tr>
</tbody>
</table>

Source: Accountancy, January 1990, p-12


HUMAN RESOURCE ACCOUNTING

Introduction

Human resources of an organization refer to the aggregate of its employees' attributes namely knowledge, skill, experience and health that are potentially available to the organization for the achievement of its goals. In other words it is the value of the productive capacity of employees belonging to the organization. Human resources are the most indispensable resources of the organization. In fact the success of the organization mainly depends upon the quality of individuals running the organization. The other resources of the organization, tangible or intangible, will fail to generate requisite value unless human resources are effectively monitored and utilized.

But although scholars are more or less unanimous about the indispensability of human resources in an organization, some experts are of the opinion that they do not deserve to be recognized as assets in the financial statements. They argue that something can be recognized as an asset in the balance sheet only if it satisfies three criteria. Firstly, it should belong to the organization legally. In other words the organization should have a legally enforceable claim to it. Secondly, it should be under the absolute control of the organization and thirdly, it is expected to generate with reasonable degree of certainty some measurable amount of benefit to the organization. According to the critics, all the three criteria are not fulfilled by human resources. People can not be owned by the organization; they can not be regarded as slaves in the modern society. Moreover under no circumstances can an organization have a legally enforceable claim to the services to be flowing from people in future. Again, as with non-human assets, employees can not be used according to the sole discretion of employers. The possibility of an employee working under more than one employer simultaneously in an accounting period cannot be ruled out. Giving status of assets to human resources, therefore, seems less than justified from the accounting point of view. It should also be borne in mind that unlike most of the assets, whether tangible or intangible, human resources do not have any sale value since they are not marketable.

Another justification given for denying recognition to human resources as assets in accounting is that tax laws do not allow capitalization of costs incurred towards the
resources or their subsequent amortization as deductible expenses in determining taxable income. Lastly, it can not be said with certainty that the organization will derive some measurable amount of benefit from its existing human resources. So critics are of the opinion that the whole system of financial accounting which has been developed over more than 500 years by constant research and experiment of academicians and practitioners will be under jeopardy if human resources are allowed to be recognized as assets in the financial statements.

The aforesaid arguments presented in support of not recognizing human resources as assets in the balance sheet do not however conform to reality. Until recently the industrial activities were predominant in the economy of most of the countries of the world. So the existing accounting system might have been compatible till then. But now the service sector plays a dominant role in the world economy. This phenomenon is discernible even in developing countries like India not to speak of developed countries. The investments in the physical assets of a growing number of service organizations like software, entertainment, consultancy etc. is very negligible. Their earnings are mainly derived from the skill and ability of experienced personnel. The lion’s share of their costs constitutes employment costs. If the return on investment in any such company is calculated on the basis of physical assets only, the return will be abnormally high. So to assess the performance of such organizations realistically, human assets should be considered along with physical assets in the capital employed. It can also not be denied that most of the employees remain under the absolute control of the organization during working hours. They also stay with the organization till their retirement or separation. So to exclude human resources, the most vital organizational component, from the assets of the organization on the pretext of non-existence of legally enforceable claim to their services seems illogical.

Another argument that there is no assurance of future benefits from human resources is also not tenable. Uncertainty in this fast moving world is associated with any kind of assets. Change in technology and production process may prematurely make a costly machine obsolete. But that possibility does not prevent the cost of purchase of a machine from being capitalized. So there is no reason why human assets should not be amenable to the same treatment.
The argument that tax laws do not allow capitalization and amortization of costs towards human resources can also not be sustained. In actual practice in many countries, the profit and loss account prepared on conventional basis is required to be redrawn for tax accounting purpose, as all sorts of expenses charged to it are not tax deductible. So human resources can be incorporated in the accounts without much problem.

An asset is recorded in the financial statement with the object of giving idea to the users of the financial statements about the prospect of enjoying service potential from it in future. It can be expected that an organization with highly talented and efficient workforce will enjoy greater service potential than those with inefficient and less effective workforce. In this sense human resources are the assets to the organization. Legal ownership is not so important here. In order to enable the users in decision making, they should be provided with the idea about how much has been invested for recruitment and development of employees and how much return is being generated by these investments.

**HRA—A LOOK AT THE DEFINITION**

Understanding the concept of human resource accounting would be incomplete if one does not have a look at its definition given by the celebrated authorities on the subject. Some of such definitions are presented below:

The American Accounting Association (AAA) (1974) has defined HRA as 'the process of identifying and measuring data about human resources and communicating this information to the interested parties'.

Likert (1967) has observed that HRA is the process of recognizing, measuring and communicating useful information concerning human resources to the policy makers and to other interested parties.

Woodruff, jr., has defined HRA as the 'identification, accumulation and dissemination of information about human resources in dollar terms'.

According to Brummet(1968), HRA is 'a logical and significant extension of the scope of enterprise accounting. It is the process of measuring and reporting the human dynamics of an organization............. to the decision makers both inside and outside the organization'.
WHY HRA is NECESSARY

The growing concern for human resource management in industries has led to the emergence of human resources accounting. Behavioral scientists concerned with management often point out the inability of the conventional financial accounting system to provide necessary information relating to the human resources of the organization. In order to achieve the short-term and long-term goals of the organization, management is required to utilize various resources optimally. To help them discharge this function effectively, they need to be provided with information regarding these resources. But they get very little information about an organization's human resources from financial accounting. This is not conducive to proper monitoring and management of variables in human behavior like group loyalty, motivation, skill, communication and decision making. In fact success of the organization depends upon how best these variables are managed and monitored.

It is also pointed out that profit as reflected by conventional financial accounting is distorted thus leading to erroneous conclusion about the performance of the business. Expenses relating to human resources e.g., recruitment, training, upgradation, incentive for skill etc. the benefit of which will be flowing over the future years are charged against the current year's revenue instead of being treated as investment. So external users particularly investors and creditors will get wrong signals about the performance of the organization. This system also renders inter-firm comparison misleading. For example, firm X spends a huge amount towards development of its human resources. As per the conventional system these expenses are charged against the current year's revenue. Another firm say, Y on the other hand does not spend any amount for human resource development and consequently its current year's profit is not impaired by HRD expenses. The apparent comparison between these two firms will, therefore, indicate that firm Y is better managed than firm X. But actually this is not the case. Firm Y is now increasing its current profit at the cost of the future. On the other hand firm X is now arranging for sustainable growth.

Traditional financial accounting makes a difference between the disclosure pattern of human assets and non-human assets. While non-human assets are duly recorded, there is no record of human assets. But it is recognized by all that human assets are the main
value drivers of the organization. Productivity and profitability of an organization largely depends upon the contribution of human assets. Two firms with same physical assets and operating under similar market conditions may register different profitability and different growth rate due to qualitative difference in their human assets. Since the value of human assets is not reflected in traditional accounting, the real assessment of the growth potential of the firm is not possible.

The conventional treatment of human resource development expenses also leads to a general inclination on the part of management to curtail such expenses. This may boost up immediate profitability but only at the cost of motivation, morale and efficiency of employees.

In order to understand clearly the impact of management decision on human resources, its value should be reflected in the financial statement. The main thrust of the conventional accounting system is on immediate profit determination. So management's attention is also directed to attaining as much profit as possible immediately. But action by management in pursuance to this goal may not be conducive to maintenance of the human assets of the organization. Thus for instance, the method of production and the mode of supervision may be changed. As a result, the level of performance may improve in the short run. But the efficiency of human assets may be heavily damaged due to high absenteeism, loss of morality, negative motivation and separation. Proper accounting of human assets may prevent such eventuality.

Proper resource-mix is very much essential in any organization for attaining its goal. For this purpose, it is necessary to estimate return from different types of resources. In order to do this management must have adequate information relating to human resources as well as physical resources. According to the relative potential of return, investment must be made in those resources. After investments have been made in those resources, it is to be assessed whether actual return is matching with expected return. Based on this assessment, management can take various policy decisions regarding utilization of and further investment in resources. It is through human resources accounting that information needs of management for the above purpose can be adequately met.
Investors and creditors can know the total value of the firm from the balance sheet if it contains both physical and non-physical assets. The future profitability on the basis of which creditors assess the creditworthiness and investors determine the viability of the organization can also be best estimated from the financial statement incorporating both physical and non-physical assets. This is particularly true in the present new economy where innovation has become a matter of life and death for the organisation. So the issue of human resources accounting, the importance of which has been felt since the 1960's can not be left unresolved any longer.

**HRA – DEVELOPMENT OVER THE YEARS**

It is to be noted that the concept of HRA first originated in the minds of behavioural scientists concerned with the management of the organization. They first felt that for proper monitoring and management of variables of human behaviour like skill, motivation, sense of belonging etc., information relating to human resources is required. So a system of accounting for human resources has to be developed to provide such information.

Some leading economists have also drawn our attention to this area and helped considerably in the development of the Human Capital School of thought. Their approach deals with the implications of various economic resources devoted to the education, training and orientation of human resources. They are mainly concerned with future returns in economic terms, such as increasing productivity, maximizing present value of earnings etc. against the investment of those resources.

Adam Smith observed that wage rates would vary with variations in education, training, skill and useful abilities of human beings. Marshall opined that a great deal of investment had moved from material capital to human capital. Fisher has included human beings in his concept of capital and his method of valuation has acknowledged the present value of future services. T. W. Schultz has felt that the value of human capital depends on the value of the services it renders, but not on the extent of investment made in accumulating human capital. He has argued that the available resources can be allocated in such a way that the total return can be maximized considering material and human investment opportunities. He has put forward a number of ideas on human capital
formation and has stressed that, through imparting knowledge and training human capital can be accumulated. L. C. Thurow has examined the logical base for human resources value and observed that the future earnings stream will be meaningful for valuation of human resources only when the value of the marginal product of the employee is equal to the payment made by the employer. Many other economists have also contributed significantly in this field. Suggestions like valuation of human capital by capitalizing the wage bill (say, at the market interest rate), recognition of the cost of people to the organization, treatment of costs of recruiting and training a new entrant as investment etc. originally came from the economists.

Thus HRA, as we understand today, has, strictly speaking, developed as a corollary to the human capital theory as developed by economists. It deals, more specifically, with the measurement of the economic value of the organizational members. The basic objective underlying this approach is to help the decision-makers in planning human resources with a view to enhancing the return of the organization and to reflect the true worth of the business through the financial statement.

MEASUREMENT OF HUMAN RESOURCES

Several models have been developed for the measurement and valuation of human resources. As with other cases of valuation none of them is appropriate in all circumstances. These models can be grouped broadly as cost based models and present value based models. Though various cost bases have been suggested in this context, the models based on Historical Costs, Replacement Costs, and Opportunity Costs seem to be most relevant for discussion.

1. HISTORICAL COST APPROACH

Rensis Likert and associates at R.G. Barry Corporation, USA first initiated this method, in 1967. It involves capitalization of costs for hiring, training, familiarization and development of employees and writing off the same over the period for which employees stay in the firm. The unexpired cost is shown as investment in human assets. If an
employee retires or expires prematurely, the value of human assets pertaining to him will be written down.

The greatest advantage of this method lies in its simplicity and easy understandability. It also ensures matching of costs with revenue. But this method gives a measure of costs and not of value of human resources. It is just like deferred revenue expenditure to be charged to successive profit & loss accounts on some basis. The costs of developing human resources cannot be taken as the real value of human assets. The real value of human assets of an organization rather depends upon the potential contribution of its employees. Hence the information regarding human resources provided by this method is not much relevant to external users who may be interested in determining the total value of the organization. Many are also doubtful about the utility of this information to management for decision making purpose.

THE CASE OF R. G. BARRY CORPORATION

The R.G. Barry corporation of the USA was the first organization that attempted to develop a workable HRA system based on the historical cost approach as early as in 1966. The management contacted R. Likert (of the University of Michigan) for advice and guidance. A team, composed of researchers from the University of Michigan and managers of the Corporation, led by W.C. Pyle worked for about 15 months and developed a system that was formally introduced in 1968. According to this system, the direct and indirect historical costs of recruitment, training and development of 95 managers – classified into first-line supervisors, engineers, middle managers and top level managers – were capitalized. In 1969, the system was extended to 155 managerial employees. Under this system 7 functional capital accounts were opened and an account was opened for each manager. The 7 accounts were a) recruiting outlay costs; b) acquisition costs; c) formal training and familiarization costs; d) informal training costs; e) familiarization costs; f) experience-building investment costs; g) development costs. Human assets account balances were amortised on the basis of the expected length of service of individuals. Training and development accounts were amortized over a shorter period of time. Operating managers reviewed the accounts quarterly and indicated write-
offs for training, experience and development caused by obsolescence. Termination of employment resulted in complete write-offs of the accounts. A proforma balance sheet was developed which reported the investment in human resources during the period the system operated. The corporation reported net investment in human resources as $9,86,084 (1969), $9,42,194 (1970), $15,61,264 (1971), $17,79,950 (1972), and $ 19,64,243 (1973). R. Likert and W.C. Pyle guided the whole exercise. The inclusion of human resources in the accounting reports generated an awareness of the economic importance of employees. The monetary loss due to turnover was focused. The capitalization of personnel development costs led to a different outlook of management. Perhaps, the company’s financial standing was more realistically represented. However, the Corporation discarded the system in 1974. R.L. Woodruff, jr., (Vice-President, Human Resources) observed that the benefits of the system were not commensurate with the costs of maintaining the system, particularly for a concern of their size.

2. REPLACEMENT COST APPROACH

This approach involves the assessment of costs for replacing hypothetically the entire set of the existing workforce by a new set of employees who are equally efficient and can maintain the organization’s current revenue. Accordingly it considers current cost of recruitment, induction, training and development of new employees to reach the level of competence of the existing employees.

Experts have developed different variants of the replacement cost model. Of them the one developed by Flamholtz is noteworthy. He has referred to two different concepts of replacement costs namely individual replacement costs and positional replacement costs. Individual replacement costs refer to the costs likely to be incurred by the firm today to replace an employee by a substitute of equal service potential. These costs may be said to reflect the value of employees to the firm employing them. But truly speaking, the value of an individual is related not only to the position currently held but also to the positions expected to be held by him in future. Thus positional replacement costs should be considered. Positional replacement costs refer to the current costs of replacing the series of services expected of an incumbent in different positions. The following steps are involved to find out positional replacement costs: (1) identification of the service positions that an individual may occupy in the firm over a specified period (say, 5 years),
(2) measurement of respective positional replacement costs of the employee and (3) estimation of the probability that the employee would occupy each position over the specified period. If the positional replacement costs associated with each service position of an employee are denoted by \( X_1, X_2, X_3, \ldots X_n \) and the respective probabilities that the individual will hold each possible mutually exclusive positions are denoted by \( P(X_1), P(X_2), P(X_3) \ldots \ldots P(X_n) \), the aggregate of positional replacement costs of different service states or positions adjusted with probabilities represents the replacement costs of an individual.

This method sounds well as it aims at finding out the current cost of the existing workforce. It is also helpful in determining managerial ranking of employees. It can assist manpower planning by providing estimates of costs involved in obtaining personnel for different positions. However, some practical difficulties exist with this model. It involves estimation of costs and probabilities of likely service states of each employee. These are then aggregated to arrive at total replacement costs of all employees. The entire process is laborious and costly. An average firm may not find it economically feasible. It is also not clear how far the information regarding replacement costs of all employees can help the management and investors in decision making. Moreover this method is not theoretically sound, as replacement by similar employees is hardly possible. The estimation process involved in this method may also be highly subjective.

3. OPPORTUNITY COST MODEL

Under this model it is considered that an employee has value to the organization only when he/she can have alternative use in the organization. If alternative positions are available for an employee, his value to the firm will be determined by the competitive bidding method as suggested by J.S. Hekimian and C.H. Jones. Under this method, managers of different departments requiring an employee will bid for him and the highest bid for him will be taken as his value to the organization. Thus the total value of human assets would be the aggregate of the individual values of the employees. So this model assumes that an employee who can be readily hired without any bargain has no value to the firm. Only scarce employees represent the human assets of the firm.
The main advantage of this model is that it ensures optimum allocation of employees between different departments through the bidding process. It can also provide information for developing a quantitative base for planning, evaluating and developing human resources in the organization. But this method can not provide the value of total human resources of the organization as it excludes from the valuation process those employees who have no alternative uses. Secondly, it is an uphill task to identify the alternative uses of an employee’s service in the organization. Even if such identification is possible, managers require judgement and impartiality while bidding for an employee. This ideal situation can hardly exist in actual practice. Thirdly, the assumption that scarcely available employees are capable of rendering service in different departments is absurd. A specialized employee can be expected to have skill in one area only. So this model of human resources valuation has, truly speaking, no application in actual field.

PRESENT VALUE APPROACHES

LEV AND SCHWARTZ MODEL
Under this model, the present value of a future steam of earnings of an employee from the firm is taken as the surrogate measure of his value to the firm. According to Lev and Schwartz, the proponents of this model, “the value of human capital embodied in a person of age X is the present value of his remaining earnings from employment.”

Thus this model involves estimation of a future stream of compensation likely to be received by an employee and restating them at the present value with a suitable discount rate. The present value of future earnings of an employee is considered as his value to the firm. So this model is based on some assumptions namely—

(a) Future earnings of an employee can be estimated
(b) Period of his employment in the firm is known
(c) Discount rate applicable to a person is determinable.

In actual practice the total strength of the organization is divided into homogeneous categories such as skilled, unskilled, semi-skilled, engineers, technicians, accountants etc.
The average earning of each group is estimated for the range of ages, say 25-35, 35-44, 45-54 and 55-64. The total income that each group will be earning up to the dates of retirement are estimated. This is then discounted to arrive at the present value of earnings of the group. The sum total of the present value of earnings of all groups will provide the total value of human capital of the firm.

This model is, strictly speaking, a cost based approach to the value of human capital. But it provides a measure of the future estimated cost. Thus it may be considered a better approach to evaluation than the historical cost surrogate. Moreover the proportion between the values of human resources and that of the non-human assets can indicate the magnitude of labour intensity of the firm. Third, the present values of prospective earnings of the organization may be compared with that of its working force. By comparing this ratio all over the industry, the relative efficiency of the firms can be judged.

The basic shortcoming of this model is that it considers the future earnings of employees as an asset of the company. It is assumed here that earnings of employees are equal to the benefits derived from the payments to them. This is not very logical. Secondly, it ignores the promotion and career advances of employees during the service period. Thirdly, the model considers only the wage profile of employees. The costs of recruiting, training and retaining human resources are ignored here. Fourthly, the subjectivity involved in determining the level of future salary, the length of employment and the discount rate affects the validity of the model. Fifthly, the method does not help in appraising past investments in the development of individual employees since the value is determined on the basis of the average staff.

**ECONOMIC VALUE MODEL**

Under this model, the value of human resources is determined based on the contribution expected to be derived by the firm from the employees. In estimating the possible contribution from employees in future, the probability of change in position in future is duly considered. The possibility of separation from the organization is also taken into account. The value of an employee to the organization is the sum of the values of services
he is likely to render in different positions during his service life. The total expected service might thus be obtained as follows:

\[ E(s) = \sum_{i=1}^{n} S_i \cdot P(S_i) \]

Where \( E(s) = \) expected total service

\( S_i = \) expected service to be derived from each position occupied by the employee during his service life.

\( P(S_i) = \) probability of expected service.

The value of service of an employee is determined by multiplying the estimated quantity of output to be generated by him by its price. The total value thus ascertained is restated at present value with an appropriate discount rate. The present value of the total services of all employees is treated as the human capital of the organization.

This model of human resources valuation seems to be logical as it is based on the expected future service of the employees. However, it is very difficult to apply this model particularly in case of those employees whose services can not be quantified. There is also a lot of subjectivity involved in the estimation of the probabilities of services an employee may render in different positions. Employees' behaviour on the basis of age, qualification, previous experience, length of service etc. are to be duly considered while quantifying the service expected from employees. But it is next to impossible to do it objectively. So validity of this model is yet to be proved.

**Chakraborty's model on human resources accounting**

Professor S. K. Chakraborty developed a comprehensive model of human resources accounting specially keeping in mind the Indian situation. He advocated the inclusion of human assets under the head 'Investment' in the balance sheet. His argument was that such arrangement would help avoid the problem of depreciation, capital gains/losses etc. on exit usually associated with fixed assets. To treat human assets as current assets is also, according to him, absurd, as human assets are not meant for conversion into cash.
within a year. Investments are usually valued at costs and thus treatment of human assets as investment would be a more feasible method as compared to the valuation models based on future service potential of employees. Chakraborty further suggested the valuation of human resources in the aggregate and not on individual basis. Managerial and non-managerial manpower may be evaluated separately. The value of human resources (on group basis) can be determined by multiplying (a) the average emoluments of the group (estimated on the basis of the organization’s salary grade structure, promotion policies, etc. by (b) the average tenure of service of the employees in the group (estimated on the basis of past experience of the organization/industry). After aggregating the values of the groups, one can have an indirect measure of the value of contributions from the employees. He further suggested that expenditure relating to recruitment, induction, training and development should be recorded separately for each employee. The sum total of such expenditure should be treated as deferred revenue expenditure to be written off over the average expected service period (as estimated earlier) within the organization. The deferred portion should be shown in the balance sheet. In case of premature termination, the balance in the deferred revenue expenditure account attributable to that employee should be written off against the revenue in the year of separation. As the discount rate, Chakraborty suggested that expected average after-tax return on capital employed over the average service period (estimated earlier), if possible, or over the next five-year period be taken because, adoption of such long-term rate would help to avoid fluctuations in the valuation of human resources from year to year. Each year, whatever balance remains in the deferred revenue expenditure account should be added to the value of the human resources determined. The annual salaries, etc. would however be written off against revenue in the profit and loss account for the year. This could be considered as a surrogate for depreciation in the sense of expiry of value in use of the human resources. But that would be a departure from the ‘investment’ concept of human resources.
Empirical testing of uses of Human Resources Information

Although the concept of human resources accounting originated long back, its full-fledged implementation in actual practice is yet to take place. Some empirical tests have been conducted with a view to inquiring into the uses of human resources information. Out of them two are noteworthy. In 1970 Nabil Illias (Ghosh, 1985), a researcher of the University of Minnesota attempted to assess whether decisions based on financial statements incorporating human assets would be different from those based on conventional statements. The study revealed that decision outputs differ significantly. The limitation of the study was that it was concerned only with assessing the impact of human resources accounting on investment decisions. Secondly the study was based on the historical cost based HRA. It did not reveal the possible impact of other measurement models on decision making. Lastly it covered only a small section of users of financial statements and that too in a small area of the State of Minnesota. So its findings can not be generalized although it can be taken as a guide for further research. In another research study conducted in 1975 (Ghosh, 1985), the researcher M.A. Sangeladji tried to find out how far the data on human resources are considered useful by different groups of people associated with the firm. The study revealed that different groups perceived different degrees of usefulness of human resources information. While managers perceived lowest utility for such information, other users perceived a higher utility. It was also revealed in the study that users would prefer human resources information by way of a supplementary statement rather than as a part of conventional financial statements. The survey indicated that many users were not sufficiently familiar with human resources information. Many of the respondents did not express strong preference for receiving monetary information about a firm’s human resources for decision making. Some however, showed great interest in receiving and utilizing non-monetary information like age, experience, education and health of senior managers, stability and loyalty of employees, record of employee turnover, sales per employee, labour relationship etc. Sangeladji’s study also suffers from some limitations. It dealt with only two measurement models i.e., discounted wages/salaries model and historical acquisition costs based model and studied their usefulness mainly to potential investors in investment decisions. No attempt was made to assess the usefulness of HRA information to other
categories of users namely creditors, labour union and governmental agencies. Thus the findings of the study are not conclusive. No generalization about the usefulness of HRA information can be made from the study.

**Conclusion**

From the above discussion it is evident that HRA is still in its infancy. A lot of problems both conceptual and operational have to be overcome for ensuring its full-fledged application in the actual field. But one can still proceed with that available model most suited to its condition by making logical estimates and assumptions until some better model on HRA is evolved. This is because success and growth of an organization solely depends upon its human resources. So the importance of information relating to these resources both to managers and users of financial statements in their respective decision making can not be ignored. Reporting on these resources based on any of the models as discussed is much better than providing no information at all.

**RESEARCH AND DEVELOPMENT**

In order to ensure future stability and growth, it has now become the practice of large companies to spend huge sums of money on research and development (R&D). 'Research' is defined as investigation directed towards the advancement of knowledge in general or in a specific area with the aim of developing a new product or service. 'Development' is the act of translating the research findings towards the introduction or improvement of specific commercial products or processes. There are a number of empirical evidences (Griliches, 1995; Lev, 2001) that a strong positive correlation exists between R&D expenditures of a firm and its profitability and growth. The study conducted by Lev (2001) over eighty-three publicly traded chemical companies covering the period 1980-99 revealed that while investment in R&D yielded around 17 percent after-tax return that in physical assets yielded more or less 8% after-tax return. This means that investment in physical assets does not do more than maintain status quo. The study further indicated that the return to R&D of companies investing
considerable resources in R&D is substantially higher than the R&D return of low investors in R&D. The research work of Griliches (1995) has brought to light the fact that the contribution of basic research (i.e., work aimed at developing new science and technology) to the productivity and growth of the company is substantially larger than the contribution of other types of R&D such as product development and process R&D. The former is approximately three times larger than the latter. This revelation is very significant in as much as companies generally have the tendency to curtail expenditure on basic research, which is considered more risky than applied research. But taking risk in basic research is, as noted, is more than rewarded. These research findings are of great significance to managers who are to allocate the scarce resources most judiciously to various activities.

**Accounting for R&D expenditure**

Accounting for R&D expenditure is a very controversial issue. Some authorities prefer its capitalization while others are in favour of its immediate write-off to the profit and loss account. Those who are in favour of capitalization and systematic amortization give the following arguments:

a) Companies spend large amounts on R&D with the intention of earning future profit, not as an overhead expense necessary for current production. So deferral of R&D costs is more logical.

b) Immediate write off is likely to distort the trend of profit, depressing the profit in the year in which the expenditures are incurred and inflating the profit in the subsequent years.

c) The immediate write off method may encourage the management to curtail research so as to boost present earnings just when research is required to maintain market position or efficiency.

In support of the writing off method, it is argued that:

a) A high degree of risk is involved in R&D activities. So as a matter of prudence it should be immediately expensed away.

b) The writing off method ensures matching of cash flow with profit.

c) The deferral method calls for the exercise of subjective judgement regarding future revenue, while the writing off method is quite straightforward.
d) There may be considerable practical difficulties in measuring the future benefits arising out of R&D activities. So it is better to write off R&D expenditures immediately.

Some of the R & D activities lead to invention that may enhance the earning of the company considerably. Again some of the R&D activities do not become successful. While charging of the R&D expenditures which have been proved unsuccessful can not be called in question, R&D expenditures which have not been proved unsuccessful within the accounting year should not be charged. Even if R&D expenditures on a project are expensed away till the project passes the feasibility test, the entire project related previously expensed R&D expenses should be recognised as assets once it passes feasibility test. However the universal practice is to expense away R&D expenditures as and when they are incurred and keep this investment hidden even if the project becomes successful. As a matter of fact, it has been found that there is a very strong positive investors’ reaction (share price increases) to corporate announcement of new R&D initiatives (Lev, 2001).

CUSTOMER RELATION VALUATION

There are many organizations that are dependent on their relationship with customers for revenue generation. This long-term relationship with customers has a great intangible value to the firm. For example, in service-based enterprises such as those involved in the business of Consultation, Telecom Services, Banking and Software Development, this intangible value is quite significant. The valuation methodology usually adopted for valuing customer relationship is based on 'remaining useful life analysis' of the customers and its impact on future cash flow. It is assumed that customer relationship is a valuable intangible but will decay over the years. The incremental earning stream on account of the existing customers over the expected life span is determined and their present value is taken as the value of customer relation.
The segregation of earnings arising from customer relation is a very difficult task and requires careful study of the revenue stream. The professional bodies are yet to issue any guidelines regarding customer relation accounting. Because of high degree of subjectivity in its valuation, accountants are yet to put much importance to it.

Computer-Related Organisation Capital

Of late companies are spending a huge amount in computer and software development. This is being done for achieving an efficient supply chain management, production function and disseminating information about the company. It has been empirically found that investment in information technology has a very favourable impact on the market value of the firm. While investment of a dollar in physical assets is valued in the capital market at approximately one dollar on an average, each dollar of investment in information technology brings ten dollars of market value (Lev, 2001, pp.63). The increase in the value of the firm is the reflection of the value of organisation capital, not just of computer. Brynjolfsson and Yang (1999) explain this phenomenon as follows:

“Our deduction is that the main portion of the computer-related intangible assets comes from the new business process, new organisational structure and new market strategies, which each complement the computer technology..... More recent studies provide direct evidence that computer use is complementary to new workplace organisations.....As IT (information technology) is a new technology still being developed rapidly, IT investment may accompany considerable changes in the structure and behaviour of organisations.....Wal-Mart’s main assets are not the computer software and hardware, but the intangible business process they have built around those computer systems.....Amazon’s website and the computer hardware infrastructure are only a small portion of their total assets, but the accompanying business model and business process that support the model are quite valuable... the value of the business data about customer information, supplier information and business knowledge is several times as large as the cost of disc storage itself.”

PATENTS

A patent is an exclusive right to a design or idea, which is conferred by law allowing the holder to use the same in manufacturing and marketing the product for a specified period of time. The majority of costs incurred with internally developed products to be patented
are related to research and development activities and, as such accounted for accordingly. Costs, which are capitalized for patents generally relate to registration costs, including technical drawings made specifically for the purposes of registration and sometimes unrecovered costs of successfully defending patents.

The cost capitalized as patent is generally amortized over its legal life. However if it appears that the economic life of the patent will be shorter than its legal life, it is amortized over its economic life.

**Copyrights**

A copyright usually confers an exclusive right to control the publication, distribution, or performance of written, musical, or other works. The costs of establishing the actual copyright are usually capitalized. These costs are amortized over the period of expected revenue generation from the copyright or the copyright life whichever is shorter. Very often as a matter of conservatism the cost of copyright is written off over the period of the first edition.

**Franchises, Licenses, and Royalty Agreements**

These usually confer the right to the franchise, license, and so on to carry on a business, to operate a process, or to have access to technology to which the grantor had an exclusive right previously. Initial payments and associated acquisition costs, such as legal fees, are, generally capitalized. These are amortized over the period during which economic benefit is likely to be derived from them by the firm.

**FAVOURABLE LEASES**

A typical instance of a favourable lease is where a leasehold property is acquired along with the business and the rent is well below the current market price. In this case it would be logical to ascribe a fair value to this intangible benefit. Usually the present value of differential rent for the period up to the next lease renewal date is considered as the value of this asset.
NON-COMPETE AGREEMENTS

This type of agreement is generally entered into as part of the acquisition of a business, where the seller gives undertaking of not doing a similar business for a specific period. The valuation process of this benefit is very subjective. The probability that the seller would have competed and the likely impact on the cash flow under these circumstances are usually considered. The period over which this value will be amortized should be determined based on the life expectancy of the seller, if he or she is an individual, and the life of the product, which the buyer is seeking to exploit commercially.