Valuing Intangibles is Still Under the Dome: From AS to IAS

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1. Introduction

Besides from the statement that the investment in fixed assets brings higher returns, none can deny the fact that there can be several other key performers to yield better returns to the equity holders which are of equal importance. The sales and EBIT can't reflect the sole impact of the any key variable, however the investors as well as the interested parties to the financial information when checks the fundamentals, ignores many aspects of due importance. These factors and variables are predominantly known as "Intangibles". Intangibles are not synonymous with the intangible assets shown in the balance sheet. Intangible asset is merely a sub-set of the intangibles. International Accounting Standard, IAS 38 defines an *intangible asset as an identifiable non-monetary asset without physical substance.*

The said concept of this head of assets as mentioned in IFRS (International Financial Reporting Standards) is widely accepted and followed by the companies. But scholars have still found some missing links between the investment in these hidden forces and valuation of the companies. The past researchers have found that the definition of the intangible assets is pro-manufacturing companies but the changing scenarios of times have come up with subjective classifications of assets. Firstly, many of them are not recorded as their economic benefits are not known or they can't be measured in cost. The adverse most affect of this missing information is "information asymmetry". Secondly, the issue is even more heated when the portion of the "input of services" is dominated over the "input of goods". Shifting attention from manufacturing sectors to the services based sectors, puts the importance on valuating the firm in a precise manner. Thirdly, the parameters like self generated goodwill, competitive advantage of the human resource and experience of the company may not be overlooked that gracefully.

Fourthly, even the Dot com bubble burst in the technology sector was due to the undue exuberance in the market. All the intangibles are far beyond the measurement. Lastly, neither the conventional inconsistent methods bearing accounting biasness nor any uniform definition or model is apt for all the sectors. A sector wise distinct – or some industry specific measure can only serve the purpose.

Leonard I. Nakamura (Federal Reserve Bank of Philadelphia) included three different parameters of intangible assets in economy – an accounting estimate of R&D, software, brand development and other intangibles; the wages and salaries paid to the researchers, technicians and other creative workers who create the intangible assets; and also enhances the operating margins from intangible factors.

Generally Accepted Accounting Principles by and large involve the expensing of internally generated intangibles. The reasons portrayed so far are the dilemma of estimation and also the uncertainty of generating economic benefits in future. The corporations on their part are not merely missing the capitalization of this potential asset but they also compel the investors to be asymmetrically informed. The informational gap is always a hurdle to the market efficiency. Here more informed investors trade more actively to exploit the scenario. The variables' list that defines the internally generated goodwill is not a close ended one. The factors like experience of an organization, human resource expertise etc are not covered under the head of intangible asset. And finally, it is not only physical capital that brings competitive advantage to the firm rather several crucial factors are awaited to be known as a key factor to create value to the firm.

2. Literature Review

Hancock (2007) investigated the association between the intellectual capital(IC) of firms and their financial performance. The paper uses the Public framework, has an Asian focus tested four elements of IC and company performance. The findings show that: IC and company performance are positively related; IC is correlated to future company performance; the rate of growth of a company's IC is positively related to he company's performance; and the contribution of IC to company performance differs by industry. IC is an area of interest to numerous parties, such as shareholders, institutional investors, scholars, policymakers and managers. The findings help to embolden modern day managers to better harness and manage IC.

Chansa-ngavej (2008)aimed to propose a framework for intangible asset management in business and industrial organizations. There are two phases, the top-down phase involving a four-step intangible asset identification process and the bottom-up phase establishing the cause-effect relationships between the intangible assets of the various functional departments in the organization and its financial performance. Intangible assets belong to different functional departments. They must be carefully monitored and properly nurtured by the organization. Intangible assets depend not only on the type of functional departments but also the type of industries. To be competitive in today's knowledge economy, it is vital for business and industry to identify and locate the intangible assets in their functional departments and then establish how they contribute to the financial performance of the organization. Once the intangible assets are brought under control, properly managed, and suitably funded will lead to tangible benefits and competitive advantage.

Dorestani (2009) examined the link between non-financial Key Performance Indicator (KPI) disclosures and firm accounting based performance, market based performance, quality of earnings, and analysts' forecast accuracy. Millions of stocks are traded in the United States every day, and any relevant information, whether financial or non-financial can improve the efficiency and effectiveness of the capital markets. It was hypothesized that proper KPI disclosures are positively associated with accounting and market-based performance, quality of earnings, and analysts' forecasts. No significant association between KPI disclosures and analysts' forecast was detected. Overall results suggest that KPI performance and reporting are emerging and require companies in each industry to consistently provide KPI disclosure. I have shown that voluntary nonfinancial KPI reporting may not be informative to capital market participants. Results may be informative to policy makers, firm managers, and educators to continue research in this important area.

Nazari (2010) aims to explore and recognize the relationship between components of intellectual capital and a company's financial success. Intellectual capital has become one of the primary sources of competitive advantage for a firm. Within the new knowledge economy, it is important forfirms to be aware of the elements of intellectual capital that would lead to value creation. The results of the study added to the body of literature by providing additional evidence on the interconnection of IC components (Human Capital intensity (salaries, wages, pension

costs, profit sharing and incentive compensation, payroll taxes and other employee benefits), Advertising Intensity and R & D Intensity). The empirical results showed that human capital is positively and significantly associated with structural capital. Furthermore, a positive significant relationship between human capital and firm's financial performance was found.

Furthermore, better output variables of structural capital need to be used, but are not yet available in the current disclosures in financial statements. However, the value of IC might be realized through the interaction of structural capital and human capital as these two components are highly correlated.

Maditinos, D. et al (2011) have examined the impact ofIC on firms' market value and financial performance. The empirical data were drawn from a panel consisting of 96Greek companies listed in the Athens Stock Exchange (ASE), from four different economic sectors, observed over the three-year period of 2006 to 2008. Various regression models were examined in order to test the hypotheses included in the proposed conceptual framework. Results failed to support most of the hypotheses; only concluding that there is a statistically significant relationship between human capital efficiency and financial performance. IC is increasingly recognised as an important strategic asset for sustainable corporate competitive advantage. Results proved that, in the Greek business context, the development of human resources seems to be one of the most significant factors of economic success. Focusing on human capital should, therefore, be at the centre of the companies' attention.

Bubic & Susak (2015) identified Intangible assets as important factor which can significantly contribute to financial position and profitability of a company. Recently, importance of intangible assets is considerably increasing what is indicated by higher investments that companies make in this component of non-current assets. The main objective of this study is to identify relationship between investment in intangible assets represented by intangible assets to total assets ratio and financial performance of companies represented by various financial ratios. Also, relationship between investment in intangible assets and bankruptcy status will be determined. Mainly, profitability ratios as Return on Assets, Return on Equity, Net Profit Margin, Gross Profit Margin etc. are used as measures of financial performance. The empirical findings are based on sample which consists of companies that operated in Republic of Croatia. The sample comprises of two groups. First group consists of

companies which opened a bankruptcy proceeding and second group consists of companies which haven't opened a bankruptcy proceeding. The companies included in sample are classified in two activities - manufacturing industry and wholesale and retail industry.

In conclusion after going through the past studies, it can be said that the modern business requires companies to invest in intangible assets. However, investment in intangible assets also requires management to use them efficiently in order to create new value and preserve the business continuity. Although studies have considerable relevance to check association between financial performance and intellectual capital, but still unidentified parameters could still be studied.

3. Conceptual framework

Marr and Schiuma (2001) quoted that Intellectual capital(IC) is the group of knowledge assets that are attributed to an organisation and most significantly contribute to an improved competitive position of this organisation by adding value to defined key stakeholders'. Intellectual capital includes the patents, trademarks, copyrights which are legally protected. As far as Intellectual capital is concerned, it can be both the end product of a knowledge transformation process or the knowledge itself i.e. converted into intellectual property. In 2009, Cantu, Bustani, Molina, & Moreira defined Intellectual capital as the sum of all knowledge that is possessed by all individuals in an organization that can generate value for the organization and provide the organization with a competitive advantage.

The IC estimation has been made possible by several models: the Balance Scorecard (contributed by Kaplan and Norton, 1992), Brooking's (1996) Technology Broker method, Edvinssion and Malone (1997) Skandia IC Report method, EVA and MVA model (Bontis et al., 1999), Market-to-Book Value model (various authors),. Tobin's q method (Luthy, 1998), Pulic's VAIC Model (1998, 2000), Knowledge Capital Earnings model (Lev and Feng, 2001) and the list crosses over to 30 such models.

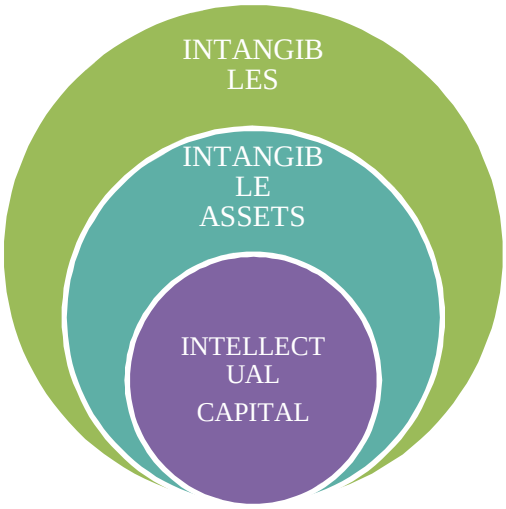

Figure 1: Defining Intellectual capital, Intangible assets and Intangibles

International Accounting Standard, IAS 38 defines an *intangible asset as an identifiable non-monetary asset without physical substance.* An asset is identifiable if it either:

a. is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or
b. arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

An intangible asset shall be recognised if, and only if:

a. it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
b. the cost of the asset can be measured reliably.

Intangibles are not defined so far in a lucid manner. All the factors covered under IC and Intangible assets are not complete to define Intangibles. It is still a broader concept. The combined effect of tangible assets as well as intangible assets is the final outcome of firm that makes actual sales possible. The synergetic result of all intangible assets, human resource and other self generated assets that assists the organization to gain value in the market is defined as *Intangible s*in this study. It is a common thread in between of creating value. It is a source of competitive advantage.

4. Objectives of the study

i. To ascertain the factors affecting return on equity of the industry specific market portfolio.

ii. To propose the missing parameters of firm's value creation other than the tangible assets.

iii. To study the determinants of valuation of firm as far as intangibles are concerned.

iv. To analyze the variables classified as intangible asset under the IAS.

v. To identify the intangible factors that can make the head "intangibles" more informative from valuation point of view.

5. Hypotheses of the study

H_{01} :There is no significant factor affecting return on equity of the industry specific market portfolio.

H_{02} : There is no missing parameter of firm's value creation other than the tangible assets.

H_{03} :There is no significant intangible determinant of valuation of firm .

H_{04} : There is no difference between the variables classified as intangible asset under the IAS and the intangibles contributing to the value of the firm.

H_{05} :There is no other intangible factors that can make the head "intangibles" more informative from valuation point of view.

6. Methodology

The study is predominantly based on the secondary sources. The definition of intangible asset as given by the International accounting standard (IAS) which is also widely accepted by the organizations list in the top stock exchanges. Besides the concepts of the intangible asset given by scholars is discussed as an enhanced measure. The study is intended to be of descriptive nature discussing the theoretical aspect of the concept of the intangibles. The study is based upon theoritical justifications.

7. Intangibles in queue: The Synergy Effect

Contesting the distinct variables as a probable measure to keep track of the disguised source of value creation that has been overlooked for so long, some essential variables are

Intangible assets, Human resource and self generated assets. The Intangible assets are accepted as a source of value creation of the firm and also seen in balance sheets.

Human resource: The human resources are key performers of every organization. They are the one who make them or break them. By human resources, it means not only the top level executive but also middle level and factory level employees too. The technicians, the engineers, the managers, sales personnel etc. all contributes on their part to get the goals of organization accomplished. The firm success might be measured in terms of sales turnover or market capitalization but the infinite number of hands are joined together to make it happen. Financial capital and fixed assets are vital for the corporate houses but the cordial moves and efforts of the employee bring it to the reality. Now raises the question that how to record the Human resources as a measure. Accounting standards have clearly stated that only the intangible assets which can be measured on cost can be taken into account under the head. The actual cost of Human Resource can be measured as the sum total of salaries, wages, bonus, commissions, training and development incurred on them. As a rational employer, the organization would spend on them as much the can pay back the firm and also as long as they are working with the firm. As the definition of asset, claims that the organizations have claim over the asset. In case of HR, the claim of organization is there only as long as they are employed.

The notion of human capital is not very new to be highlighted. The renowned studies by Bontis, Cabrita, Roos and Roos, Keow, Richardson, Choo finally asks the readers what is left in an organization when employees leave? Proclaiming the importance of the employees, without whom the firms could not be thought of running even a single day.

The human resources are the one to bring the fame and are a source of competitive edge in the organization. In order to consider anything as an asset, the same should be recorded on cost and the organization should also have a claim over the same. As far as human resource is considered, the economic benefits generated by them is not always the same as the EBIT of the firm, it is even beyond. The totality of the return generated by them may not be materialized in the valuation of the firm to the fullest. The human resource is not a cost, they are the assets.

The concept of self generated asset is given birth by the combined effect of assets and human resources. The results are embalmed within the market value. The self generated asset includes predominantly the internally generated goodwill. The self made goodwill is a latent

variable. It is a function of age of the firm (experience gained), selling and advertisement expenses (brand building), size of the firm (economies of scale). The parameter of appropriating the intangibles is not parameters individually rather they reach the heights if and only if all of the distinct variables move in a positive direction to contribute the financial performance of the firm. Even if the precise number of intangibles is still under the microscope, it is a proven fact that intangibles create the majority of corporate value today, and as a consequence, the two companies with similar assets carry different market values. The accounting standards be it AS or IAS both are missing the methodology to study intangibles to study financial performance and from valuation point of view.

8 Key Findings about the hidden forces

In order to tag any product for price what come to the mind is the cost and the entrepreneur's profit. If that be the case, then what fetches that high in monetary terms on selling the art pieces painted by Amrita Shergil and Leonardo Da Vinci or the apparels designed by Tommy Hilfiger and Hidesign? Is that merely the total cost of producing and the added profit or some aspects are still misplaced to value such products? The conventional concept of putting these two factors (cost + profit) forward might fit to handful of trading units but not where there is huge matter of repute is accompanied with. At a parallel go, the innovativeness of the firm, exceptional effort of the human resource and synergy of the combinations maintained by the organization among the four (including the goodwill) is also a subject matter. The root cause of the missing measure for all the self-generated ideas and intangibles is not always the lack of cost at which they could be recorded. But many a times the risk factor (that whether cost incurred will be a productive innovation or a wasteful expenditure) is actually what puts it under the limelight.

IAS 38 refers an intangible asset as an identifiable non-monetary asset without physical substance. An asset is identifiable if it either is separable; (capable of being separated from the entity and sold) arises from contractual or other legal rights. Monetary assets are money held and assets to be received in fixed or determinable amounts of money. The accounting standards measure the assets on cost basis but it might leave an informational gap when Tech companies, service based companies, pharma companies are to value there assets. If at all the reasons for the Dot-Com bubble is to be published, then often heard is the idea of overwhelming and irrational exuberance in the tech companies which was led due to overlooking the role of self-generated

intangibles. Baruch Lev also reported that the intangibles can be classified into innovation (may be protected by patents, trademarks and copyrights), unique organizational structure, brand value and human resource practises. The standards even have a measurement standards for livestock (in Ind AS 41: Agriculture), residual value of property, plant and equipment (Ind AS 16), but no precise measure has been formed for intangibles to be valued although acquired intellectual capital has found the recognition.

Gone those days when all expenditures and assets incurred by the firm could be reported in the balance sheet. If things would have been consistent, then what deviates the book value to the market capitalization of most of the firms, Tech companies, service based companies, pharma companies in particular. Scholars have put forth the concept of balanced scorecard, Value Added Intellectual Capital, MTB (market to book value) and Tobins q to infuse the alternate options to tap the performance but a standardised measure is still awaited.

Defining intangibles as “the assets which lack the physical existence” is not always sufficient. Reasoning them is an issue that makes accountants and investors even more curious. Saying no to intangibles gracefully is not the solution. The notion behind this article is to put the need for the valuation standards in the public domain and make the scenario not pro-innovation which should not be heading towards imitation or sheer acquisition.

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