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INTANGIBLE ASSETS IN THE ANNUAL FINANCIAL STATEMENTS OF THE COMPANIES

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Abstract: *Intangible assets are generally not included in the financial statements of the companies. Many companies do not recognize or investigate ways to maximize the income to be derived from intangible assets. It is generally accepted by the academicians and as well by the practitioners that investments in intangibles are important sources of future profits. However restrictive accounting asset recognition rules mean that most intangible assets cannot be included in the balance sheet, especially if they are internally developed. Instead, all costs incurred to develop intangible assets are usually charged as expenses in the income statement. For companies which invest in intangibles, this immediate expensing means that the current profit and net assets of a company with high R&D costs' level are reduced, while future reported profits are often overstated. In this article I make an attempt to focus on problems by identifying and recognizing in the financial statements internally generated intangible assets, that are mainly product of non-project development activities, e. g. research and development costs. In conclusion I propose a possible way to avoid to some degree the problems with presenting intangible assets in financial statements.*

Keywords*: Intangible assets, IFRS 38, IFRS 3, economic value.*

With the change in economic conditions due to the transition from industrial to information society, investments in intangible assets are becoming increasingly important for enterprises. There are radical transformations that alter not only the organization and functioning, but the very nature of the economy[1]. The external users of financial statements and the companies themselves are interested in proper development of approaches, scope and methodology of financial disclosure in order to synchronize it with the new economic realities, as the financial information is a basis for the functioning of markets for allocation and reallocation of capital. If the system of accounting rules for compiling financial statements is only formally fitted to perform such a role, this redistribution in the global economy would not be optimal.

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[1] Веселинова Н., Възможности на контролинга за управление на маркетинговите дейности от фирми опериращи на международните пазари, Сборник с доклади от научна конференция на младите изследователи, ВСУ „Черноризец Храбър", УИ 2012, стр. 274

New economy, although described with different names in the literature[2] is economy driven by information and knowledge as opposed to so-called "old economy". Unlike the time before the fifties of previous century, nowadays there is a shift from mass production to production based on intensive use of knowledge.

As a result of such economic development emerged a new type of enterprises based on knowledge.[3] Such enterprises have few if any tangible assets, thus intangible assets displace physical capital as the main source of value. The result can be summarized as fallows: There is a change in the nature of corporations and the assets they use and need.

On the other hand investors tend to react to the impact of changes in the economy on business in real time, regardless of the delayed coverage of these processes in financial reporting. The consequence is that the deviation between market and book value of companies increases.

It can be concluded that the reasons for investments in intangible assets are mainly two: the change in the way businesses function as a result of global economic transformation to information society and secondly the associated change in the investment decisions of investors.

The described processes determine the increased interest of financiers, accountants, managers, statisticians, financial analysts and regulatory bodies to those assets, and from the perspective of investors and creditors - mainly the possibility to assess their value and the income from them. Source of the most reliable information about an item of property, and related items in the income, cash flows and costs is the financial statement. To be useful for making economic decisions by its users, the information presented must be relevant and reliable. Therefore, this article will attempt to analyze the adequacy of the presentation of intangible assets in the financial statements of the companies.[4]

In the Conceptual framework for financial reporting is written down: **"Asset.** An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. [F 4.4(a)] "

Based on these general criteria: **"An asset** is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably." [F 4.44]

In addition to the general asset definition, the definition in IAS 38 Intangible assets states:

Intangible asset is an identifiable nonmonetary asset without physical substance. Identifiable means that it is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract) or 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. [5]

[2] Post-industrial economy, knowledge-based economy, service economy, knowledge society, research intensive society, knowledge economy, information age

[3] B., Nick. "Intellectual Capital: An exploratory study that develops measures and models", *Management Decision*, 36, 2, 63-76.

[4] The analysis will be fulfilled in accordance with the rules in the composition of IAS/IFRS.

[5] IAS 38, par. 11 and par. 12

Moreover, under IAS 38 rules the possibility for recognition of intangible assets in the financial statements is based on their origin - they are divided into two main types - externally acquired and internally generated assets. To be recognized, assets should not only be controlled by the enterprise, but identifiable. When the asset is received from outside the enterprise it is always identifiable as a result of the acquisition, has a monetary value and is probable that economic benefits will flow to the acquirer. Consequently, these assets are part of the property and can be recognized in the financial statement. Internally generated intangible assets are not always recognized as such for accounting purposes. Often they are not identifiable due to legal protection, but are identifiable because of their economic nature and may be subject to a legal transaction. Unidentifiable intangible assets are neither legally protected nor can be subject to a transaction and the resulting ownership rights can not be acquired, i.e. it is considered that they are not market realizable. Accounting incorporates unidentifiable intangible assets of the entity under the concept of "internally generated goodwill." In the accounting legislation there is no definition of this concept because this kind of goodwill is not reflected in the financial statements. This does not mean that investments in creation of such assets are not made on purpose. Rather similar to the other ones, those are also being developed in order the enterprise to obtain economic benefit.

As another condition the definition states that to recognize a resource as an asset, the entity must be able to control it. For the purposes of control criterion is crucial whether the entity has the power to dispose of the asset. To establish whether there is a control must be implemented other criterion - the entity has a right to future economic benefits. For the criterion is fulfilled, the entity must be able to limit third party access to economic benefits from asset, and to assume the risks of its use.

In general, ownership determines the right to control an asset. In terms of IAS control right does not coincide with the legal understanding of the subject. The control criterion is applicable in accounting in accordance with the principle of "substance over form", i.e. asset can be controlled and in the same time it is not necessary to be owned, such as manufacturing know-how.[6]

Concerning the application of common features drawn to intangible assets, there are some peculiarities. First, to establish the existence of intangible assets in the enterprise and consequently the possibility of their identifiability should exist evidence of their occurrence in the past. In other words, to proof the existence of an intangible asset an entity must have physical evidence. Though it should be noted that the material component does not determine the economic value of the asset, only proofs his economic existence in the enterprise. This understanding is included for example in terms of property rights, but it is applicable in the same sense to intangible assets. These rights are inherently intangible assets, but to be exercised, however, it should be a document based evidence for the economic (and legal) ownership over them, and limited access of third parties to earn from their use. Thus, to ensure economic existence of an identifiable intangible asset in the enterprise there should be some physical evidence such as contracts, license, drawing, letter files and the like. Examples of an intangible asset are customer bases, which confirmation can be customer lists, contracts

[6] Under a legal agreement for transfer of know-how, one relinquishes a fact, not right, the subject of the assignment are knowledge, skills, experience, which at the time of the conclusion are inaccessible to the party seeking to acquire. From a legal point of view the Commerce act in Bulgaria governs the contract for a transfer of know-how as a license agreement.

for future and past deliveries, subscription and subscriber lists. With regard to developed and patented technologies, trademarks, copyrights - those are relevant registration documents. With respect to unpatented technology or otherwise named as know how those are drafts, drawings, sketches, instructions, charts, memos and so on.

The existence of material evidence, however, does not determine whether the intangible asset has an economic value to the enterprise. And value of intangible assets is created by its immaterial substance and by the economic benefits of owning it. Economic benefits can be reflected in an increase in revenue or decrease of costs. Economic benefits are measured by comparing the magnitude of the economic income inherent in the asset with the magnitude of the income which the owners would realize if they did not control the asset.

For recognition of intangible assets in the financial statements along with the definition should be executed two more general criteria: asset can be a subject to reliable financial estimate and it is probable that future economic benefits from its use will flow. The emphasis is on reliable valuation of the asset and the probability. Consequently in respect to the first criterion the possibility of evaluating the economic value of the asset is the leading requirement. Between value and evaluation is generally a difference. The evaluation process can be regarded as determining the value for accounting purposes, which may be different from the economic value of the asset to the enterprise. Therefore the accounting standards, that are treating different assets' groups, including IAS 38, provide rules on so-called "initial measurement". This is the input value at which an asset is recognized in the accounting. Hence cost is measured differently depending on the genealogy of an intangible asset. Upon acquisition through a transaction with a third party it is easily identifiable and recognition criteria are met. Upon acquisition of an intangible asset through its development in the enterprise the cost of purchase is his production cost and for it to be recognized in the financial statements must be completed six additional criteria. In IAS 38 is made conditional distinction of the stages of asset's production in two phases - research phase and development phase. According to the standard's rules in the first phase should be analyzed the requirements, that the asset is made for through evaluation of the alternatives for its use and as a result it should be created a prototype formula or recipe. Then the project is tested for recognition, i.e. whether it is technically feasible, an entity has a financial resource to complete it, the intention and ability to use or sell the asset, the manner of determining the probable future economic benefits and reliable determination of the expenditures attributable to the intangible assets during its development. In the following development phase the costs are capitalized and the cost of the asset is finally determined. This approach assumes that all purposefully generated intangible assets that pass through the described process must be recognized in the financial statement.

Brands, mastheads, publishing titles, customer lists, and items similar in substance that are internally generated should not be recognized as assets.

Notwithstanding within the IAS there is a possibility of recognizing and measuring the aforementioned intangible assets, that is regulated by IFRS 3 Business Combinations. To qualify for recognition, intangible assets must meet the definition of the Framework for the Preparation and Presentation of Financial Statements to the date of acquisition and be part of the acquired business and not a result of separate transaction.[7]

[7] IFRS 3, par. 11 and 12.

As a result of the requirements in IFRS 3 for the acquirer might arise three possible groups of assets, subject to recognition:

- Assets that were recognized in the balance sheet of the acquiree and are included in the balance sheet of the acquirer at the acquisition date;
- Assets that were recognized in the balance of aquiree, but do not meet the definition of an asset and are not recognized in the balance sheet of the acquirer;
- Assets that were not recognized in the balance of aquiree, but on date of the business combination meet recognition requirements and therefore are recognized in the balance sheet of the acquirer.

According to the problems discussed in this article it's interesting to investigate the opportunities for recognition of assets from the third group. Logically, the acquirer will recognize intangible assets for which there was a restriction within the meaning of IAS 38. These are mainly internally generated intangible assets which are classified for purposes of recognition and measurement in illustrative examples to IFRS 3. In terms of initial recognition standard identifies the following classes of intangible assets that can be distinguished:

- Marketing-related intangible assets - Trademarks, trade names, service marks, collective marks and certification marks; trade dress; newspaper mastheads; internet domain names; non-competition agreement.
- Customer-related intangible assets – customer lists; order or production backlog; customer contracts and related customer relationships; non contractual customer relationships.
- Artistic-related intangible assets – plays, operas, ballets; books, magazines, newspapers and other literary works; musical works; pictures and photographs, video and audiovisual material.
- Contract-based intangible assets – licensing, royalty and standstill agreements; advertising, construction, management, service or supply contracts; leas agreements; construction permits; franchise agreements.
- Technology-based intangible assets – patented technology; computer software and mask works; unpatented technology; databases; trade secrets.[8]

Initially the assets are measured at fair value on the date of business combination.

From the analysis of the rules for recognition and measurement set out in the considered accounting standards for internally generated intangible assets can be derived some important conclusions.

First there is no doubt that the IASB supports the view that these kind of assets can generate future economic benefits for the enterprise as they are included in the range of recognition. Such treatment is evident for the view, supported by the author, that independent of their genealogy intangible assets possess economic value for their owner.

Secondly that economic value can be measured for financial statement's purposes. The approach is based on current measurement basis and consists in determining the fair value of identified intangible assets. Therefore, there is an accounting estimate for internally generated intangible assets, even their cost can not be determined in the period

[8] According to the illustrative examples to IFRS 3.

incurred. In other words, they are measurable for the purpose of financial reporting. Regarding the methodology of evaluation of intangible assets acquired in business combination, IAS 38 provides guidance for applying the valuation approach adopted in the standards generally.

Tree levels of evaluation are developed by the IASB: The first is quoted market prices in active markets. The second is a fair value determined on the basis of transactions with similar assets. The last third level is the value of the asset, calculated by applying valuation techniques in the market, income or cost approach. On the other hand by the application of fair value as an indicator for measurement after recognition, paragraph 78 and following state, that it can be determined only in case that an active market for the asset persists. Generally it is not allowed another way for defining the fair value of an intangible asset, which makes it virtually impossible for companies to apply revaluation model to the majority of intangible assets. Therefore it be concluded that for internally generated intangible assets this model is highly relevant by determining an input value, and in many cases it’s also the only applicable for example when they arise in the course of business, not as a result of planned design. Next, the concept of "active market" as defined in IAS 38 can not adequately be applied to intangible assets, as in transactions with them at least prices are not available to the public, with few exceptions such as some types of software. Certain kind of market for intangible assets exists and this is the market for business combinations. There they could be identified, assessed, bought and sold. This market could serve as a reference indicator for evaluation.

Defining a broader recognition range IASB in fact distinguishes between intangible assets on a different basis, i.e. not according to their origin. Formally assets acquired in a business combination are bought in a transaction (in accordance with the definition - as a result of a past event), but in practice the fact that for the acquisition of another entity, the acquirer has paid a total cost is not directly related to their identification. Identifiability of an asset as a result of a past event does not mean that in all cases the establishment of the cost of its acquisition, i.e. connection with specific costs, is a necessary condition for identifiability. More significant is that this approach distinguishes between intangible resources, which generally can be classified and valued for accounting purposes and those that do not meet the definition and criteria for recognition as assets because they are purely economic advantages that can not be distinguished from the business as a whole and contained within what standards identified as "goodwill." In the group of unrecognized assets are included such intangibles as trademarks and trade names, customer bases and others that have arisen due to the nature of business, but are not recognizable under the requirements in IAS 38. But when goodwill arises from a business combination these assets are separated from it because they meet the definition of intangible assets and can be assessed in accordance with the benefits that are supposed to bring. Therefore, there is inconsistency in the treatment of one and the same object in individual accounts and consolidated financial statements. More importantly, in relation with the new economic conditions, they bear value for companies, bear revenues, which ultimately reflect in retained earnings. As a result of these circumstances, especially in high tech, pharmaceutical, biotech and other branches specialized in the production of intangible assets, the internally generated intangible assets, including goodwill, determine the market value of companies significantly higher than the carrying value of their net assets. This difference and its impact on investment decisions and hence on trade in capital markets are subject to attempts to define, measure and classify intangible assets for which no information is included in the financial statements in a number of theoretical and empirical research.

A survey by the Canadian Institute of Chartered Accountants proves that intangible resources are seen as critical to the success of the company by the top managers of companies in the Canadian Financial Post 300 and US Fortune 500.[9] The largest software manufacturer in the world, Microsoft has realized more than 90% revenue from the sale of standard software. Simultaneously, the company occupies a leading position in the lack of information in its financial statements for the value of intangible assets. Already in 1996 the market capitalization of Microsoft has exceeded 11.2 times the book value of its tangible assets. “The missing value" is largely the market value of intangible assets of Microsoft, which found no place in its financial statements. In contemporary practice of financial reporting this is a rule rather than an exception and illustrates one of the major limitations in the existing accounting model. There are studies that show that between 50-90% of the value that firms create comes from management and use of intangible assets.[10] According to the latest statistics of OceanTomo the share of intangible assets in the market value of the S & P 500 for the period 2005-2010 amounted to 80% vs. 20% in favor of the tangible ones.[11]

In 2007 KPMG made a survey in companies operating in Germany, but unfortunately their number is not mentioned. It was devoted to the not recognized in financial statements intangible assets, their importance to generate value for companies and matters concerning their management.[12] The introduction states that IAS 38 and IFRS 3 deal in detail with issues related to financial reporting and measurement of intangible assets. However, consistent treatment has not been achieved yet. One of the conclusions that the consultants of the auditing company reached is that more than 50% of companies perform systematic identification of unrecognized intangible assets on its balance sheet through inventory and managers indicate that the proportion of unrecognized intangible assets in the overall composition of assets amounted to 64%. As most significant for the performance of the company of the total intangible assets, managers identify the brands, relationships with customers and licensing agreements. 62% of respondents believe that unrecognized in their financial statements intangible assets may be sold separately.

The examples confirm the view that intangible assets are a priority for business in current economic conditions. They exist in industry and contribute significantly to generating revenue and profits, and hence the distribution of dividends, no matter whether these assets are reflected or not in the financial statements. In the case with intangibles can be argued that the legislation is indebted to the business. Restrictive rules for recognition of intangible assets adopted in IAS 38 reflect highly the quality of financial statements. On the other hand the rules for recognition of intangible assets in IFS 3 show that they could be covered by the accounting in a more adequate way. In this respect I believe that this approach is more appropriate for the fair presentation of financial position and could, by a specific adaptation be applied outside the context of business combinations. And even more, as indicated in the example above, managers have developed techniques for inventory and identification of unrecognized intangible assets in their enterprises. Otherwise, though it claims to be

[9] Stivers, B. P., T. J. Covin, N. G. Hall, and S. W. Smalt. Harnessing corporate IQ. CA Magazine1/04, 1997

[10] Hope, J., and T. Hope. Competing in the third wave: The ten key management issues of the information age. Boston, Harvard Business School., 1998, стр. 172.

[11] http://www.oceantomo.com/productsandservices/investments/intangible-market-value

[12] KPMG,Patente, Marken, Vertraege, Kundenbeziehungen – Werttreiber des 21. Jahrhunderts. http://www.kpmg.de/docs/StudiePatente_211207.pdf

"prudent" the accounting treatment of internally generated intangible assets leads to mismatching the cost for creating them with revenue from their use. The costs are taken up rapidly and completely within the periods of their execution, and revenue from these costs are realized in subsequent periods, which results in financial results. Cash flows from operating activities are burdened with payments that are actually inherent to the investment activity. This practice is convenient for avoidance of significant value of depreciation costs, and where appropriate – impairments too. Even if the investment costs can not be directly included in the price of an asset, they can be estimated based on market value of the company and in accordance with the valuation principle in IAS 38. Moreover, even those assets will be recognized in case that certain additional criteria are met, they are often not capitalized in the balance sheet due to the possible alternatives for implementation of accounting rules. For example, many large companies, software vendors recognize as current the entire cost of development under the pretext that the costs incurred after technological feasibility of achieving (working model) are insignificant or that technical feasibility of the project can be determined prior to final completion.[13]

Hidden intangible assets generate value that managers wish to increase and shareholders to receive. The requirement set by the IASB that they should be identified and evaluated in accordance with IFRS 3 is not accidental. The value of intangible assets should be amortized systematically and when needed – impaired in order to match with revenues stemming from control over them. Not least, it seems that the goodwill reached unbelievable portions, reaching 80%, 100% and more then 100%[14] of the equity of large companies, because the companies include almost all the acquired intangible assets in it. The introduction of rules for identifying and evaluating internally generated intangible assets in business combinations do not lead to satisfactory results, according to a survey of KPMG.[15] For management of the acquiring company a possible inclusion of additional assets in the entity's property is at least not desirable due to negative impact of the cost of amortization on their future earnings. Their inclusion in the sum of goodwill on the other hand is safe, as at the time of acquisition it is not associated with future losses. Management is willing to reduce any potential losses from the business combination, in order to demonstrate good financial results especially in the periods that follow the transaction. As a result of such manipulative accounting policy the major intangible asset in the balance sheets of large corporations is precisely goodwill. In periods of economic growth the goodwill will generate revenues and profits, but in times of crisis, when corporations sell their business units that operate at a loss, such transactions are followed by massive write-offs of its value through impairment.

The depicted trends are further evidence for the need of inclusion of intangible assets more fully in the financial statements. Developing the possibility of recognizing internally generated intangible assets is a step in the right direction. This possibility should be extended to intangible assets that arise in the ordinary course of business, this will not only help to assess the "missing value" of the companies, but will make the rules on accounting for business combinations really applicable, as it will reduce alternatives.

[13] See the financial statements of Microsoft for example.
[14] Handelsblatt Firmencheck "Altlasten bedrohen deutsche Firmen" Handelsblatt No. 195/ 08.10. 2008
[15] Intangible Assets and Goodwill in the context of Business Combinations, KPMG 2010.

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NEMATERIJALNA SREDSTVA U GODIŠNJIM FINANSIJSKIM IZVEŠTAJIMA PREDUZEĆA

Rezime: Nematerijalna sredstva uglavnom nisu uključena u finansijske izveštaje preduzeća. Mnoge kompanije ne prepoznaju ili istražuju načine da se maksimizira dohodak koji potiče od nematerijalnih sredstava. Opšte je prihvaćeno od strane akademske zajednice, kao i od praktičara da su ulaganja u nematerijalna sredstva bitan izvor budućeg profita. Međutim, restriktivna računovodstvena pravila prepoznavanja imovine znače da većina nematerijalnih sredstava ne mogu biti uključena u bilans stanja, naročito ako su interno razvijena. Umesto toga, svi troškovi razvoja nematerijalnih sredstava uglavnom se prikazuju kao rashod u bilansu uspeha. Za preduzeća koja investiraju u nematerijalna sredstva, prikazivanje kao rashod znači da se tekući profit i neto imovina preduzeća sa visokim troškovima istraživanja i razvoja smanjuju, dok su budući profiti često preuveličani. U ovom radu autor pokušava da se fokusira na probleme indektifikujući i prepoznajući u finansijskim izveštajima interno generisana nematerijalna sredstva koja su uglavnom proizvod npr. troškova istraživanja i razvoja. U zaključku se predlažu mogući načini da se u izvesnoj meri izbegnu problemi iskazivanja nematerijalnih sredstava u finansijskim izveštajima

Ključne reči: nematerijalna sredstva, MSFI 38, MSFI 3.