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The accounting treatment of intangibles – A critical review of the literature

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ABSTRACT

Intangible investments have become the main value creators for many companies and economic sectors. However, these investments are rarely recognized as assets by current accounting standards. We provide a critical review of the literature on the consequences of this lack of accounting recognition of intangibles for the value-relevance of financial information, resource allocation in the capital market, growth of intangible investments, and the firm's market value. We then review recent empirical research on voluntary disclosure of information on intangibles. Our survey concludes that disclosure can considered as a solution to the negative consequences of non-recognition of intangibles in financial statements.

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1. Introduction

The nature of investment made by companies has drastically changed during the last two decades: in addition to the investment in tangible capital, several investments in "intangible capital" have become increasingly important.

According to the Organisation for Economic Cooperation and Development (OECD, 2007), investments in intangible capital are competing with investment in tangible capital in some countries. For example, in 2002, the total expenditure in intangible capital was larger than the investment in tangible capital in the United States and Finland.

At a micro-economic level, several authors, such as Stewart (1997) and Zéghal (2000), reveal that intangible assets are taking an increasingly important place in a company's capital and are, in fact, becoming more important than tangible assets.

This change in investment structure expresses, according to several economists, the transition of the industrial economy towards a new "knowledge-based" economy. Indeed, several economic institutions, such as the OECD (2007) and UK Department of Trade and Industry (2004), consider intangible assets as the main source of value creation in the new economy.

However, the valuation of intangible assets within the accounting framework raises several problems relating to their identification, measurement, and control. These problems imply that the traditional accounting model, which is based on tangible assets, historical costs, and accounting conservatism, is incapable of fully evaluating the new-economy companies (Lev & Zarowin, 1999; Liang & Yao, 2005; Upton, 2001).

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Indeed, under current accounting standards,[1] most intangible investments[2] are to be expensed when incurred. The relative lack of accounting recognition of intangible investments as assets led several researchers in accounting and finance to wonder about the consequences of this inadequate accounting treatment on (1) the value-relevance of financial information, (2) the allocation of resources in the capital market, (3) the growth of intangible investments, and (4) the market value of the firm.

The main objective of our paper is therefore to provide a critical review of these previous studies. We then examine recent empirical studies on voluntary disclosure of information on intangibles versus traditional accounting reports. Our survey concludes that disclosure is considered as a solution to mitigate the negative consequences of non-recognition of intangibles in the financial statements.

The remainder of this paper is organized as follow: Section 2 briefly presents the notion of "intangibles" and its different categories. The accounting treatment of intangibles is presented in Section 3 according to both international and American accounting standards. The accounting and socio-economic consequences are detailed in Section 4. Section 5 then illustrates the role of disclosure as a solution to palliate these different consequences. The last section is devoted to the conclusion.

2. Notions and categories of intangibles

The term "intangible" covers various complementary notions which are no different in form and substance such as intangible investments, intangible assets and intangible capital. Moreover, the literature review across disciplines highlights several other concepts that can be considered synonymous with the term "intangible capital" namely "intellectual capital", "immaterial capital", "knowledge capital" and even "goodwill."

Hunter, Webster, and Wyatt (2005) go further and specify the difference between intellectual capital and intangible capital. Thus, they suggest, according to economic literature, that intellectual capital is viewed as a subset of intangible capital where the term "intangible" relates to assets without a physical substance and "capital" refers to assets retained by the organization to contribute to future profits.

This specification is, in fact, consistent with the one made earlier by Blair and Wallman (2000) – directors of the Brooking's Institution research project on intangible assets, who distinguished between three major categories of intangibles:

(1) Intangibles for which property rights are relatively clear and for which markets exist (generally can be bought and sold). Within this category, two types of intangibles can be distinguished:
   - Assets such as patents, copyrights and trade names.
   - Business agreements, licenses, enforceable contracts, and data bases
(2) Intangibles that are controlled by the firm but for which well-defined and legally-protected property rights may not exist, and markets are weak or nonexistent. Examples are R&D in process, business secrets, reputational capital, proprietary management systems, and business processes.
(3) Intangibles for which the firm has few, if any, control rights and markets do not exist, and which are tied to the people who work for the firm. Examples are human assets, structural (or organizational) assets, and relational assets, i.e. the components of intellectual capital.[3]

According to Ashton (2005), the guiding principle for Blair and Wallman's (2000) classification scheme is related to the degree of difficulty of establishing ownership or control rights and more generally the difficulty of measurement. In this sense, the third category of intangibles raises more accounting problems than the second category and far more than the first category.

Other classifications, mainly developed by accounting standard-setters, were limited to two categories of intangible assets: internally generated intangibles and externally acquired ones. In this setting, externally acquired intangibles do not generally raise accounting problems as the price of these assets has been generally determined during the transaction in monetary form. Inversely, serious accounting problems could arise when the asset is internally generated by the company.

[1] The accounting treatment of intangibles is analyzed in this paper through the International (IAS/IFRS) and American (SFAC/SFAS) accounting standards.
[2] This term particularly refers to internally generated intangible investments. A more comprehensive discussion on the accounting treatment of intangibles will be presented in Section 3.
[3] According to the literature, intellectual capital is classified into 3 categories: human assets, structural assets, and relational assets. Human asset refers to the knowledge, qualifications, skills and know-how of employees. Structural asset constitutes the supportive infrastructure that enables human asset to function in an organization. It comprises procedures, practices, computer and administrative systems of the company. Relational assets concern the resources arising from the external relationships of the company with customers, suppliers and other partners (Kristandl and Bontis, 2007; MERITUM, 2002; OECD, 2006b).

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