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The measurement and recognition of intangible assets: then and now

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Abstract

"In the Fortune 500 there are thousands upon thousands of statistics that reveal very little that's meaningful about the corporations they purportedly describe. At least that's the verdict of a growing number of forward-thinking market watchdogs, academics, accountants, and others."(Fortune, April 2001). In today's economy value is often created by intangible (intellectual) capital. The accounting profession has not met the challenge of measuring and reporting the results of knowledge-based entities. The Federal Reserve Bank of Philadelphia estimates that in the year 2000 more than US$ 1 trillion was invested in Intangibles. The problems relating to the measurement and recognition of intangibles are international in scope.

This paper reviews existing and recently promulgated US, UK, and IASC accounting standards relating to Intangibles. Inconsistencies in the measurement and reporting of Intangibles under US Generally Accepted Accounting Principles (GAAP) are highlighted, and evidence is provided that suggests that recognition of Intangible (Intellectual) Capital is in accordance with existing accounting principles In particular, the newly promulgated Financial Accounting Standards Statements on Business Combinations, Goodwill, and other Intangibles is reviewed. The objective of the comparisons to UK and IASC standards and the review is to provide evidence that will improve the measurement and reporting of intangible (intellectual) capital and facilitate harmonization. Improving the global financial reporting infrastructure will ultimately lead to the reporting of relevant and reliable quality earnings.

Keywords: Intangible assets; Intellectual capital

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1. Background

Accounting standard setters are faced with the challenge of upholding and improving the quality of financial reporting domestically, while simultaneously encouraging the development of a high-quality global financial reporting framework. The Financial Accounting Standards Board (FASB) has placed on their agenda a project entitled, “Disclosure of Information about Intangible Assets not Recognized in Financial Statements”. The European Commission—Enterprise Directorate General launched an Invitation to Tender for a “Study on the measurement of intangible assets and associated accounting practices”.

> This tender could be considered—at least in the intention of the Directorate-General’s people—as . . . European responses to the studies . . . carried out in the United States . . . on the subject of intangibles and intellectual capital. Stephano Zambon (accountingeducation.com)

The criticisms about the inadequacy of Generally Accepted Accounting Principles (GAAP) to report upon information-age activities has reached an all-time high. The terms used to describe current GAAP in the financial press runs from “inadequate” to “lousy”, with a colorful assortment of adjectives in the middle. Fortune (April 2001) describes accounting rules as irrelevant, making them the very antithesis of the objectives of financial reporting. Such popular press comments illustrate the frustration that others, outside the accounting profession, feel in trying to understand the nexus between financial reporting results and corporate performance. Given that the constituency of the accounting reports is the public, and that the public generally receives its information through the financial and other press, the dissatisfaction with financial reporting argues that the mandate of the profession to generate financial reporting standards may be threatened.

Accounting standard setters have historically been faced with the trade-off between *relevance* and *reliability*. The three major objectives of financial reporting (US) are to provide information that is useful for:

- making business and credit decisions;
- assessing the amount, timing, and uncertainty of cash flows;
- reporting enterprise resources, the claims on the resources, and the changes therein.

There has been an evolution toward a worldwide consensus that financial statements should provide decision-useful financial information. The precise wording of the concepts statements or objectives of standard-setting organizations is not the issue; *relevance and reliability* (US), or *true and fair* (UK). What matters are the results of the standards produced in terms of integrity, comparability, and transparency.

The Hierarchy of Accounting Qualities (FASC 2, 1980) lists relevance and reliability as the primary qualities that should be embodied in reported numbers. Relevance is defined as the quality of information that has the capacity for making a difference in a decision Whereas the definition of reliability include both verifiability and representational faithfulness. The trade-off decision between relevance and reliability is guided by the accounting profession’s hallmark of conservatism (prudence). The recognition of all inherent risks and