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FINANCIAL REPORTING ON INTANGIBLE ASSETS – SCOPE AND LIMITATIONS

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Abstract: *Financial statements provide primarily information about the company itself - its ability to create profit, cash flows and changes on capital, as well as its tangible and financial assets and liabilities. Contemporary business conditions are characterized by existence of the need for fulfilling various information demands of broad interest group. Lack of relevant information on intangible assets (intellectual capital and the like) in the financial statements disables the possibility for external users to perceive real value of the company and adequate decision making. Too rigid criteria for recognition and measurement intangible assets, cause the book value of many knowledge and technology-intensive companies to be few times lower than its market value. In this paper, authors analyze the scope of the existing model of financial reporting in providing relevant information on intangible assets of a company, but they also analyze the limitations that this model faces. In the paper possible directions for overcoming existing limitations are also pointed out, in order to provide relevant information about intangible assets of a company.*

Keywords: *Intangible assets, Financial reporting, Relevant information, International accounting standards.*

1. INTRODUCTION

The main objective of financial statements is to provide information about the company's financial position, business performance and cash flows. The importance of this information has never been questioned given that it is the basis for making rational economic decisions to a wide range of users. However, the immutability of financial reporting objective does not also mean the immutability of the way in which that objective is achieved. Namely, the processes of globalization, internationalization and concentration of economic power caused the traditional economy, characterized by capital-intensive enterprises, to be replaced by the new economy, which is also called the knowledge economy. In such circumstances, modern enterprises, for the most part, base their value generating and gaining a competitive advantage on intangible assets. More accurately, they became one of the key determinants of entrepreneurial values which completely changed the panorama of economic activities. In this regard, the provision of relevant information about intangible assets is one of the preconditions needed to determine the real financial and profitable position of an enterprise. Bearing in mind that the traditional model of financial reporting is not able to provide relevant information about the company's intangible assets, in the past two decades there have been numerous efforts to overcome its limitations which result in the difference between market and book value of the company. For these reasons, contemporary theory and practice see the preparation of reports on intangible assets, as a supplement to the financial statements of the company, as one of the solutions.

2. THE NEED FOR FINANCIAL REPORTING ON COMPANY'S INTANGIBLE ASSETS AND ITS IMPORTANCE

If we start from the fact that financial statements are the primary means of communication between the company and its stakeholders, then the desire of accounting, as a profession is to provide an adequate conceptual framework, which will enable the preparation of high-quality financial reports, is entirely understandables. Framework for preparation and presentation of financial statements, providing relevant data about assets, liabilities, equity, income and expenses, other changes of the equity and cash flows will enable achievement of objectives of financial statements. More accurately, by reading and analyzing them, the users will be able to:

- Get an insight into the history of the company and foresee future performance, presented through future earnings, cash flows, the possibility of fulfilling obligations, perspective in terms of creating added value and the like;
- Assess the financial structure of the company (financial health of the company) and its exposure to long-term and short-term financial risks;
- Examine the quality of financial statements presented, in terms of the existence of latent reserves and hidden losses, i.e. to assess to what extent they reflect the economic reality;
- Carry out a comparative analysis of the company with other possible investors, with the aim of capital allocating to areas of the most profitable use, which contributes to efficient use of resources, encourages investments and stimulates the liquidity of the securities;
- Discover the ability of the company to adapt to changes on the market of inputs and outputs, to the changes of technology or to resist the competition;

- Enable early detection of signal on the outlook of the company;
- Assist the evaluation of company's ability to service its obligations;
- Assess the ability of management to create added value .

Therefore, the information presented in company's financial statement are important to users, since they are the basis for making decisions about allocation of resources, which are always limited. This fact justifies the increased interest of different interest groups for events in the area of financial reporting in general, and financial reporting on intangible assets as well. This happens, primarily, for two reasons. The first reason lies in the fact that, today, the intangible assets are considered to be the key factor of value generating and the potential of growth and development of a company. Based on knowledge, education, organizational and professional experience, motivation of employees, interpersonal relations and the like, intangible assets become the main factor of material form of value creation and the creation of global competition which in the same time relativises the role of financial and physical capital. The fact is that knowledge has been the main source of long-term economic growth ever since the Industrial Revolution, however, what distinguishes its current meaning, as a generator of growth, is the fact that the information and communication technology accelerated the shift towards a knowledge economy, enabling rapid transmission of information over long distances at low cost. Certainly, the traditional factors of production have not disappeared, but they have become secondary, i.e. it is considered that intangible assets as an element of business operations, in addition to tangible assets, have a primary contribution to company's earning power. Success of the company, for the most part, is an effect of the current knowledge, skill, flexibility and management creativity, which is the key element for gaining the competitive advantage. For these reasons, the information needs of numerous users are directed towards the consideration of a "new" resource of a company, such as internally generated intangible assets, knowledge, relations with stakeholders, organizational culture and the like. The second reason lies in the fact that the traditional model of financial reporting is fraught with many limitations considering the treatment of intangible assets. Namely, the traditional model of financial reporting allows their presentation in the balance sheet only if they were acquired externally. This way, showing of internally generated intangible investments, i.e. investing in human capital, research and development, advanced technology, relations with customers etc., is absent. So, many categories of intangible assets are not adequately covered by financial statements which caused the market value of many companies, which are knowledge and technology-intense, to be several times lower than the value presented in the balance sheet. Below, as one illustration, we will demonstrate the relation between book and market value of a company, on the assumption that the book value of the company (the value of tangible assets and externally acquired intangible assets)

Table 1
Current reporting practice versus the market value of the firm

	Book value(Rs)	*Market value(Rs)*
Recorded assets including recognised intangibles	1,000,000	1,000,000
Internally generated intangible assets not recognised as assets in current practise		3,000,000
Total assets		4,000,000

The table clearly shows that Rs. 3,000,000 of the value of the company refers to internally generated intangible assets which could not be recognized or displayed in the balance sheet by the traditional accounting practice. If we look at the relation between the market and book value of the company, i.e. calculate market – to – book ratio, we will see that it amounts Rs 4,000,000. The situation showed in this way inevitably leads to the conclusion that the traditional model of financial reporting is not able to point to real property, financial or profitable position of a company. As a result, the modification of traditional accounting system, in terms of expanding the possibilities to include the internally generated intangible assets, is inevitable. Namely, the accounting profession is expected not to remain a mere observer of fundamental changes in a modern company. On the contrary, it must actively explore the ways of objective expressing in accordance with accounting principles. The decisionmakers in the area of financial standards definition are expected to set recommendations for adequate identification of intangible assets elements, a set of criteria for measurement and standards for its disclosure

3. THE CHARACTERISTICS OF THE EXISTING SYSTEM OF FINANCIAL REPORTING ON INTANGIBLE ASSETS

One of the causes of reduced relevance of the traditional model of financial reporting can be found in the fact that it ignores the internally generated intangible assets. Therefore, the professional and regulatory bodies launched the initiatives to solve the problems of financial reporting on intangible assets, suggesting that it is necessary to activate this part of property and its valuation by means of accounting standards. This enables better understanding of the financial position of the company by many users. The Standard prescribes the accounting treatment on company's intangible assets, i.e. gives the criteria for its recognition, defines the way its book value is measured and requires certain disclosures about intangible assets.

4. THE RANGE OF FINANCIAL REPORTING ON INTANGIBLE ASSETS OF A COMPANY

The intangible assets as "non-monetary without physical substance that can be identified" Companies may include the intangible assets on their balance sheet if such property meets the requirements from the definition and the criteria of recognition . Conditions from the definition of intangible assets are:

- the possibility of identification – assets can be separated from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with the related contract, asset or liability or arises from contractual or other legal rights;
- the existence of control – the entity is able to obtain future economic benefits arising from the resource and to restrict others to access such benefits. Ability to control usually arises from legal rights that are enforceable in court, although there are other ways of control.
- the existence of future economic benefits – the inflow of funds that occurs on the basis of the property (income), various types of savings or other benefits from the property used by the entity.
- Apart from meeting the requirements from the definition, for the intangible assets
- to be recognized, it is very important to meet the criteria for recognition. In this sense, intangible assets should be recognized only and only if:
- it is probable that the future economic benefits, attributable to property, will flow into an entity and
- if the cost value of the asset can be measured reliably.

If the property meets the set conditions and it was recognized as intangible asset, its initial measurement is done at cost value. Of course, as is the case with property, plant and equipment, as well as in the case of intangibles, acquisition costs include all costs necessary to prepare the property for the planned use. Subsequent expenditure, after recognition, generally does not satisfy the terms of the definition and for these reasons are recognized as expenses. After initial recognition. Possibility of recognition of intangible assets, however, is conditioned by the manner in which they were acquired. When we speak of externally acquired intangible assets, their recognition and identification of cost is relatively easy whether they are acquired through individual purchase, as part of a business combination, with the help of government grant or exchange. Certain difficulties occur in internally generated intangible assets, both with those acquired by internal activities in the company, as well as with the internally generated goodwill. Taking into account the specificity of their recognition and accounting treatment in general, we will give special attention to these categories. a) Internally generated intangible assets When we talk about internally generated intangible assets acquired through internal activities. In addition, to assess whether such property meets the criteria for recognition, an entity classifies the generating of property in two phases:

- Research phase and
- Development phase.

The phases above (classification) are based on the fact that in the contemporary conditions of business operations, research and development are essential prerequisites in achieving future economic benefits in the company. In fact, today many market leaders, primarily technology companies, achieved the existing positioning primarily by implementing these activities. In order to acquire new scientific knowledge and understanding researches – that include activities such as the search for applications of research findings and other knowledge, alternatives for materials, devices, products, processes, systems, then, the formulation, design, evaluation and final selection of possible alternative – are being conducted. Accordingly the expenditure incurred at this stage is recognized as an expense when incurred, which implies that intangible assets arising from research cannot be recognized. The reason is that these costs arise at the stage where it is impossible.

5. THE LIMITATIONS OF FINANCIAL REPORTING ON INTANGIBLE ASSETS OF THE COMPANY

Intangible assets are characterized by a specific way of recognition and measurement, which greatly complicates the development of adequate, understandable and comprehensive accounting standards. A significant step forward in establishing a single set of rules and principles of accounting for intangible assets. Though it resolves most of concerns related to the recognition of company's intangible assets in financial statements, there are certain limitations that this standard has not yet been able to overcome. Namely, based on the precautionary principle, this standard provides a very rigorous criteria for the recognition of certain intangible assets, primarily internally generated (research and development costs, talent and knowledge of employees, trademark, etc.). The above reason, the impossibility of establishing a connection between the cost of intangible assets and future economic benefits, in some cases may be linked to property, plants and equipment. However, it clearly excludes internally generated intangible assets rather than to accept their recognition and reliable testing. In addition, there are still no unified elements of internally generated intangible assets, or the possibility of standardization of intangible performance and their inclusion in the official financial statements.

6. DIRECTIONS FOR IMPROVEMENT OF FINANCIAL REPORTING ON INTANGIBLE ASSETS OF THE COMPANY

The information that the existing practice of financial reporting on intangible assets provides are useful but, at the same time, insufficient to determine the real value of the company. For these reasons, the issue of providing relevant information about intangible assets is a significant challenge for today's accountants. To be specific, the improvement of practice of reporting on intangible assets was the subject of research of many theorists and practitioners.

Create a new conceptual for reporting on intangible assets. The framework for reporting refers to the voluntary preparation of reports on intangible assets which completes the existing set of financial reports, thereby ensuring an adequate communication of the company with the external stakeholders on the issue of intangible assets and business performance;

Create an environment that will encourage the reporting improvement. The Working Group recommends the protection of companies which are willing to perform additional disclosures, primarily through new legislation. Also, the companies should provide disclosures of more sophisticated and less certain (less secure) information, as long as they point out that this information are uncertain and while they provide the explicit explanations on how these information were constructed

Within these projects, directions, recommendations, rules and principles for adequate evaluation and reporting on intangible assets are given to users. The experiences of these companies suggest that this report provides information that reduces the gap between market and book value of companies. Also, based on the information of mentioned report, the information asymmetry between management, owners and investors was reduced, and the uncertainty and insecurity of investors and creditors were reduced as well, resulting in greater access to new sources of financing companies and significantly improved communication with investors, banks and capital market. Better external reputation was established due to the increased the confidence of all stakeholders in the reliability of business management. Specifically, the uncertainty and risks of cooperation with such companies are significantly decreased, because what was usually invisible is now made visible.

CONCLUSIONS

Satisfying the users' need for information, in terms of giving them insights into the economic realities of the company, is the primary objective of financial reporting. For these reasons, any part of the assets, liabilities, event or transaction which could affect the current financial position and future company performance should be presented in the financial statements. Therefore the financial reporting meets the requirements of eco- Financial Reporting on Intangible Assets – Scope and Limitations Significant progress, in terms of removing restrictions of traditional accounting treatment of intangible assets, was accomplished .This standard prescribes the treatment of intangible assets of a company, that is, determines the criteria for their recognition, defines the way of measurement of their book value, and requires certain disclosures about intangible assets. However, setting up too rigorous criteria for recognition of, specifically, internally generated intangible assets, leads to the conclusion that their coverage will remain outside the scope. Namely, it is unlikely that these assets will find their place in financial reports. For these reasons exactly, today the efforts are being made for addition of the set of financial statements on intangible assets (intellectual capital) as voluntary reports, rather than as a radical reform of the existing financial reporting system. Accordingly, it can be noted that a number of projects result in recommendations to practitioners for evaluating and reporting on intangible assets. The experiences of many companies suggest a much wider range of these reports, which encourages the voluntary preparation of these reports, and also sets the basis for further improvement of existing practices.

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