

**POTENTIALLY DYSFUNCTIONAL IMPACTS OF
HARMONISING ACCOUNTING STANDARDS:
THE CASE OF INTANGIBLE ASSETS**

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ABSTRACT

Intangible Assets as a category within accounting and reporting disclosures have become far more noticeable in recent years, including large amounts associated with brands, mastheads, franchises, and patents. Many of these items are not purchased but internally generated within the organisation, and may account for much of the difference in magnitude between book value and market capitalisation.

The International Accounting Standards Committee has recently issued IAS 38 to regulate the reporting of intangible assets, and includes therein the prohibition of those intangible assets, which have been internally generated. This prohibition would cut across recently developed practices in Australia and New Zealand. The problem is compounded by an increasingly close relationship between IASs and the national standards of both Australia and New Zealand, making it very likely that the problem areas within IAS 38 will be transferred to the national standards.

This paper examines the areas within IAS 38, which are likely to lead to undesirable consequences, both for internally generated intangible assets but also in terms of the reinforcement of somewhat conservative aspects of financial accounting including historical cost and the inhibiting effects on new developments generally. The possible compounding effects of an expectations gap between the traditional and expected role of financial statements is briefly examined as a possible explanation of the divergence of opinion between different groups involved in the development of accounting standards and reports.

1.0 INTRODUCTION

Developments in international accounting over the past decade have been increasingly concerned with the harmonisation of accounting standards, and through them, the increased standardisation and enhanced comparability of external reports from multinational corporations (Radebaugh and Gray, 1996; Haskins et al., 1996; Ma, 1997). Most recently, the International Accounting Standards Committee has been attempting to rejuvenate the range of International Accounting Standards and present them as an alternative to national accounting standards systems, or at least as a model to be followed by national systems. This strategy has been partially successful in that many countries, including Australia and New Zealand and many countries in the Pacific Region, are now most concerned to maintain or enhance the degree of conformity between their national standards and those of the IAS system (Ma, 1997).

Although there are many benefits to be gained from the reduction in conceptual and practical reporting differences, the possibility that encouraged/mandated harmonisation/uniformity could have a distorting effect on financial reporting does not appear to be considered at the present time. In other words, harmonisation of accounting standards will only be a good thing if the standards themselves are good standards. This paper is concerned with one example of the downside or dysfunctional aspect of such a drive towards harmonisation, namely, the effects that IAS 38: Intangible Assets could have on current reporting practices in Australia and New Zealand.

This paper considers the impact which adoption of IAS 38 Intangible Assets could have on Australasian (and other) accounting statements, particularly where interesting developments in the areas of brand values and other intangibles would be stifled in the quest for harmonisation of disclosures. Although the examples and literature drawn on in this paper are predominantly from Australia and New Zealand, the authors are concerned to emphasise that the message they are trying to convey has wider implications. The major accounting standard setting operations, whether US, UK, or IAS, do not have all the answers to contemporary accounting and reporting problems, especially in terms of the newer developments. Furthermore, the issue of an expectations gap as discussed in the latter part of the paper appears not to have been given sufficient discussion in most of the English language accounting literature excepting in relation to auditing.

The remainder of this paper is structured as follows. In the second section, the main provisions of IAS 38 are outlined; The third section is devoted to an examination of the implications of these provisions for existing disclosures, consistency between disclosures of related cases, the effects on the future development of accounting for intangible assets will be examined and the conflict between the proposed standard and existing conceptual frameworks.

The next section considers the accounting expectations gap, which may go some way to explain why there are conflicts between groups within the accounting discipline on the development of disclosures, and also discrepancies between conceptual frameworks and the standards that are based upon those frameworks. A concluding section attempts to bring the paper to a logical end.

2.0 MAIN PROVISIONS OF IAS 38: INTANGIBLE ASSETS

The main impact of IAS 38 (ED-87 in New Zealand) comes from the requirements in respect of the Recognition of Intangible Assets. In addition to the proposal:

that an entity recognise an intangible asset, if, and only if:

- (a) it is probable that the 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.

there is a prohibition “that internally generated goodwill, brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as assets.” (ICANZ, 1999, p.2-1273).

Any intangible asset, which is recognised, will have to be periodically revalued, either at cost less accumulated amortisation and any impairment losses, or at a revalued fair value with reference to an active market. There should also be systematic amortisation over the useful life, which should not normally exceed 20 years.

The treatment of internally generated intangible assets is thus completely differentiated from that of acquired intangible assets. Furthermore, a heavy emphasis is placed upon cost less amortisation/impairment costs with the fair value method requiring an active market for the specific asset type or class.

In addition, as part of the implementation of IAS 38, an entity might be required to alter the carrying amounts of items recognised as intangible assets. All internally generated brands would have to be removed; so also would any intangible assets for which the historical costs are unknown. Adjustments would also be necessary to provide for appropriate levels of amortisation of accepted intangible assets.

IAS 38: Intangible Assets may be described as a very conservative approach to accounting for intangible assets and internally generated intangible assets in particular. The standard would impact on many corporations, which have experimented with new forms of information disclosure, and also discourage further developments, whilst reinforcing the historical cost convention. The next section

considers some of the impacts which IAS 38 might reasonably be expected to have on current and future disclosures by Australian and New Zealand companies if adopted in the present form as national standards in those countries.

3.0 POSSIBLE IMPACTS ON DISCLOSURES BY AUSTRALIAN AND NEW ZEALAND BASED COMPANIES

A number of possible impacts have been identified arising out of the relationship of IAS and national standards in Australia and New Zealand, including (1) forced changes to existing valuations, (2) restricting the development of useful and relevant information (3) consistency between internally generated and purchased intangible assets, (4) reinforcing the status of historical cost, and (5) the relationship between IAS 38 (ED-87) and Conceptual Frameworks

IAS 38: Intangible Assets was issued in September 1988. Although not immediately applicable to Australia and New Zealand, countries with well-developed accounting professions, standard setting bodies and conceptual frameworks, an IAS has a high standing through policies designed to foster long-term agreement between domestic and international standards.

The Australian Accounting Standards Board and the Australian Accounting Research Foundation issued an International Harmonisation Policy in April 1996, which states *inter alia*, that::

- 5.3 In relation to their work programs, the Boards will endeavour to:
 - (a) use existing IASs as the basis for developing corresponding Australian accounting standards when addressing topics. (ASCPA, 1999, POL6 p.4).

In the case of New Zealand, the recently issued exposure draft ED-87: Accounting for Intangible Assets is stated to be "... a direct copy of IAS 38 except for some minor amendments to its terminology and format to ensure ED-87 is consistent with other New Zealand pronouncements" (ICANZ, 1999, p.2-1269).

It is quite clear from the above that IASs are now to be taken as the basis for national standards in Australia and New Zealand. This must mean that to the extent that these standards are good or bad the effect will flow on into the national standards; such may be the price of harmonisation.

It may be argued that IAS 38, if adopted, would have major impacts on existing disclosure practices, as well as important inhibiting effects on future developments in disclosures. In attempting to follow a more conservative path (and perhaps earn greater recognition from proponents of US GAAP?) IAS 38 would prohibit the disclosure in accounting statements of internally generated intangible assets whilst maintaining or reinforcing a traditional treatment of purchased intangibles. Furthermore, the effect

would not only be to effect forced changes to values and to reinforce a lack of consistency between internally generated and purchased intangible assets, but also to restrict the development of useful and relevant information. In addition IAS 38 would perpetuate the hegemony of historical cost over other valuation approaches. These issues will be considered in the following sections.

Heaton and Lont (1999) have identified wide discrepancies between the values shown in Statements of Financial Position and the market capitalisation of the entity. Specifically a service organisation such as Telecom New Zealand had only 7% of the market value recognised on the balance sheet. According to the University of Otago database the relationship between book value and market capitalisation for the market as a whole was of the order of 62%. Some of the balance sheet figures will include internally generated intangible assets, such as brands, which will be excluded under the new standard. Therefore, the gap will become wider not narrower over time.

The likely effect of the adoption of IAS 38 and ED-87 may be gauged from the extensive schedule of transitional provisions requiring:

1. Adjustment to the goodwill figure for intangible assets acquired in a business combination, if the intangible asset does meet the definition within the standard.
2. Derecognising the item if it was not acquired in a business combination and does not meet the definition within the standard.
3. That where the intangible item meets the definition within the standard, and was recognised at cost, it should be classified as an intangible asset and the cost deemed to be properly determined.
4. That where the intangible item meets the definition within the standard, and was recognised at a value other than at cost, it should be classified as an intangible asset, and the carrying cost re-estimated.
5. That where the intangible asset was acquired in a business combination that was an acquisition and part of recognised goodwill but not previously recognised as an asset, the carrying amount should be measured at cost less accumulated amortisation, and the goodwill adjusted retrospectively.
6. That where the intangible asset was not acquired in a business combination it should not be recognised.
7. That where the asset was not previously amortised or the amortisation charge was deemed to be nil, the carrying amount of the asset should be restated to accommodate the accumulated amortisation.
8. That where the asset was previously amortised, but accumulated amortisation is different from that calculated under this standard, the change should be dealt with as a change in accounting estimate.

9. The elimination of the effect of any revaluation where there is no active market for the asset.
10. Restatement of the carrying amount of an intangible asset where it has not previously been amortised.

The major impact is likely to come from the derecognition of intangible assets not purchased individually, the revaluation at cost of those which have been revalued where no active market exists as defined within the standard, and the imposition of amortisation schedules where these have not previously been used.

The lack of consistent treatment between purchased and internally generated intangible assets engendered by IAS 38 has been raised by Leo (1999) in a brief but timely article. Leo (1999) drew attention to the main aspects of IAS 38, particularly the lack of consistency of treatment, which would result from the application of this standard to Australian corporate disclosures. This inconsistency arises despite a stated position from the IASC that with regards to intangible assets:

The Board's view, consistently reflected in previous proposals for intangible assets, is that there should be no difference between the requirements for: (a) intangible assets that are acquired externally; and (b) internally generated intangible assets, whether they arise from development activities or other types of activities (Leo, 1999, p.31).

Despite this stated position, which many would support, the standard is not going to produce this result. As Leo (1999) stated "...if the principles for acquired intangibles were adopted for internally generated assets, many of the criticisms of IAS 38 raised by the large corporates and accounting firms would be satisfied" (p.31).

Leo (1999) has argued that there are three main areas of inconsistency between the accounting for acquired and internally generated intangible assets. These are initial recognition at cost, measuring fair value, and accounting for brands. The emphasis on initial recognition at cost as the preferred approach was noted by Leo (1999, p.31) in the following terms:

It may be strictly correct to state that acquired and internally generated intangibles are both treated the same in that both are being recognised at cost. However, even though the assets are in substance the same, initial recognition at fair value is allowed for acquired intangibles but not for internally generated intangibles. Acquirers are being given an advantage not available to those who generate their assets internally.

Apparently, internally generated intangibles are not recognised because "...it is difficult to determine the fair value of an intangible asset reliably if no active market exists for the asset". Although IAS 38

will only accept fair value with respect to an active market for internally generated intangibles (where there are allowed to be included) acquired intangibles may be valued by estimation based on the best information available.

Accounting for brands, mastheads, publishing titles, customer lists, domain names, and items similar in substance is affected by Para 51 of IAS 38 which states that where these are internally generated they should not be recognised as intangible assets in the published accounts. Where these are acquired externally there is no similar prohibition on brands or mastheads.

Leo (1999) argues persuasively that consistency requires the recognition of all brands and similar items or alternatively none at all. He concluded:

Under IAS 38, the accounting requirements for externally acquired intangibles are more liberal than those for externally generated intangibles. This result contravenes the IASC's stated policy that there should be no difference between the requirements for externally acquired intangible assets and internally generated assets. Hopefully, the AASB will pay more attention to logic and common sense in determining the Australian standard on accounting for intangible assets (Leo, 1999, p.32).

Heaton and Lont (1999) have commented on the New Zealand Exposure Draft ED-87 that has been described as almost identical to IAS 38. The authors noted that:

...rather than representing a step towards better financial reporting, ED-87, if adopted, will further entrench the accounting profession's traditional position where reliability in financial reporting is emphasised at the cost of relevance (Heaton and Lont, 1999, p.68)

and argued for a less conservative position to provide more useful information, such as brand values by advancing methods for their valuation rather than opposing their inclusion in accounting reports.

The authors noted that the figure for equity on the balance sheet includes internally generated intangibles at valuation less amortisation, but that there is no requirement for consistency between companies. The most frequently quoted cases in New Zealand are the major brewers; with one including the valuation of brands and the other not doing so. The problem of consistency is clear, however, the issue of relevance is equally important.

Heaton and Lont (1999) noted that there is a discrepancy of the order of 50% between the book value of the entity and the market capitalisation of major listed corporations. The gap is becoming greater as

the proportion of corporate assets held as tangible or purchased intangible decreases compared to internally generated intangible assets. Thus, conventional accounting as reinforced by standards such as IAS 38, becomes less relevant because accounting reports include a smaller and smaller proportion of total economic variables over time.

Heaton and Lont (1999) indicated some of the possible impacts of ED-87 on the usefulness of external financial reports. Firstly, the prohibition on the inclusion of internally generated brands means that the reported value is decided, not by any economic measure, but by the method used to acquire the brand. Secondly, the revaluation of brands is only acceptable if an active market exists. This means that revaluations are not highly likely. Thirdly, intangible assets must be amortised over a maximum (normally) of twenty years. The balance sheet will bear no relationship to the true value of the intangible asset (where purchased) because it will be based on cost less an arbitrary figure for amortisation.

Any consistency which may be claimed for this treatment compared to that for tangible assets does not improve disclosure or the usefulness of the accounts.

The authors conclude that ED-87 (and therefore IAS 38) takes an approach that suggests that difficult measurement issues are to be avoided, in part because of problems with subjectivity and verifiability by auditors. Whilst this may be one explanation (the IAS/US GAAP association may be equally valid) the future of the accounting discipline is not assisted by this approach, especially when the value of modern entities is becoming more dependent upon non-physical assets. New approaches, including the inclusion of internally generated intangible assets, are required to make accounting reports more relevant and useful. For these reasons, as well as because of internal inconsistencies, IAS 38 (ED-87) is a poor standard and one which should not be adopted in Australia and New Zealand.

Leo (1999), which provided many of the arguments used in section 3.3, drew attention to the emphasis on historical cost in certain parts of IAS 38 in comparison to the use of fair value and the relationship to active markets. Without wishing to reopen the debate on historical cost as a valuation method, many conceptual frameworks (including those of the IASC and Australia) do not give absolute precedence to historical cost. Other alternatives are acknowledged, even if they are not actually developed fully at this point.

It may be argued that for IAS 38 to give, or to appear to give, precedence to unmodified historical cost is ultra vires the conceptual basis of the IASC standard setting exercise. Conspiracy theorists might see this as being in line with attempts to align the IAS system with US GAAP, which is probably the most inflexible historical cost system in widespread use. Furthermore, brand valuation and disclosure has been experimented with in a number of Anglo-American accounting jurisdictions, but never in the US.

This section considers the relationship between conceptual frameworks and the provisions of IAS 38 and ED-87. The development of conceptual frameworks was intended, inter alia, to provide the basis for the development of accounting standards. However, it appears that when there are short term factors deemed to be more important, this basis is ignored. For example, standards in existence when the conceptual framework is implemented usually remain as standards until they come up for revision. This has been the situation for some time; however, in the case of ED-87 the standard setting body, the Financial Reporting Standards Board, accepts that the proposed standard does not conform to the Statement of Concepts (SC).

Para 11.1, which is entitled 'Reliable measurement of cost or other value' noted that the recognition criteria in the SC requires that an asset be recognised "...if service potential/future economic benefits will probably eventuate and the asset possesses a *cost or other value* that can be measured reliably". ED-87 refers to cost only.

If an intangible asset does not possess a reliably measured cost, it cannot be recognised. If it is not initially recognised at that cost, it cannot be subsequently carried at a revalued amount. This would mean that intangible assets that possess a reliably measured value, but for which the cost is unknown, could never be recognised under ED-87. The Board noted the inconsistency, but "... believes that the ED-87 proposal is appropriate".

Another inconsistency noted, but overruled by the Board, is that related to fair value because:

When an intangible asset is acquired in an acquisition resulting in an equity combination, unless there is an active market for that intangible asset, the fair value attributed to the asset is limited under ED-87 to an amount that does not create or increase any negative goodwill arising ... It could be seen to conflict with the *Statement of Concepts* because the value attributed to an intangible asset in such circumstances would not reflect the fair value of the intangible asset (ICANZ, 1999, Para 11.2, p.2-1286).

Para 11.3 refers to the prohibition on the restatement of expenses which leads to intangible assets being recorded at a fraction of their real historical costs, which would conflict with the SC definition of historical costs.

The conceptual frameworks used by all of the parties in this action (IASB, and Australian and New Zealand standard setters) contain features such as clauses dealing with relevance, faithful representation, substance over form, and neutrality, which could be argued to be in favour of the expansionary view of accounting. This view would include internally generated intangible assets.

Furthermore, clauses relating to the information needs of users and the objectives of financial statements, taken in conjunction with the broadening of stakeholder groups, would suggest that the argument that more information (even if less reliable in a traditional objectivity sense) would be the appropriate developmental path. Conversely, it may be argued that it is the conceptual frameworks that are the cause of the problem, since they allow the expansion of disclosure beyond that which is traditional.

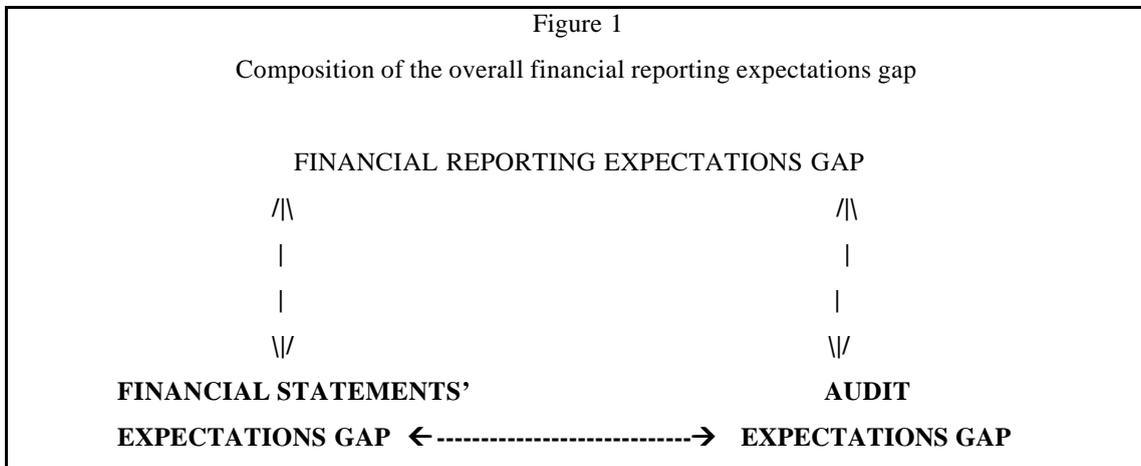
4.0 WHY DO THESE PROBLEMS ARISE? THE ACCOUNTING EXPECTATIONS GAP

Clearly there are contrary views about the directions in which accounting and financial reporting should develop. The progressive/reformist view is that more information is preferable to less information, and that useful and relevant data is more important than data which is high in the traditional values of objectivity and reliability, even if lower in terms of relevance and usefulness. Accordingly, as a generalisation, this group would welcome information about intangible assets including those which have been internally generated. This would include brands and non-financial data such as social and environmental disclosures. The wider stakeholder groups now recognised in the main conceptual frameworks, strengthen the arguments for broader categories of disclosure. Attention would also be given by the progressive/reformist group to revised valuations, not limited to strict application of historical cost principles.

The established/traditional view receives a lot of support from IAS 38 and ED-87; the exclusion of internally generated intangible assets, restrictions on the expansion of reporting, and the re-emphasis on historical cost rather than fair value, are all inclined to restrict developments and reinforce the traditional accounting values of objectivity and reliability. Concerns about relevance and usefulness are generally given a lower priority.

Can this gulf be breached? Higson (1999) has referred to this gulf as being part of the financial reporting expectations gap, containing the much discussed audit expectations gap, as well as a financial statements' expectations gap (refer Figure 1 below). Higson argued that the differences between progressives and traditionalists are the outcome of a lack of a clear basis, within the conceptual framework, about what the financial statements are intended to achieve. If different groups are trying to achieve different things through the same medium, then conflict will be inevitable. As it appears that developments in financial reporting are being tackled piecemeal, so a solution that may appear appropriate to an individual problem, may have wider ramifications in terms of what people think that the financial statements are saying. In the views of some parties, there is a real danger that putting more data into the financial statements may make them more confusing rather than more useful,

leading to a vaguer understanding of what the financial statements are trying to achieve, and thus exacerbating the financial statements' expectations gap.



Given the amount of literature on the audit expectations gap, it is surprising that there has been very limited discussion of the possibility of a financial reporting/financial statements' expectations gap (Higson, 1991; ASCPA and ICAA, 1994). Claims made regarding the usefulness of the financial statements including assessing the past, predicting the future, assisting in decision making, indicating performance, measuring stewardship, and satisfying accountability to the wider stakeholders. However, it is problematic whether such a myriad of potential users can help the standard setters produce consistent and coherent accounting standards. If the profession which is charged with the responsibility of producing the financial statements is not clear about their purpose, then it is not surprising if users may misunderstand them. The clear specification of what the financial statements are, and are not, capable of achieving would appear to be a prerequisite to tackling the financial reporting expectations gap.

Whilst acknowledging that intangible assets are an increasingly important part in the assessment of the performance of modern business enterprises, it needs to be recognised that they are only part of a greater whole. If the conceptual problem is really the corporate communication of performance and risk, the challenge then becomes one of specifying how this can best be achieved. Rather than including more detail in the financial statement (thus possibly exacerbating the financial statements' expectations gap) it is important firstly to recognise their limitations and then secondly to look for alternatives. A recent ICAEW Financial reporting Committee (1999) discussion paper set out six alternative views of how financial performance could be reported. The suggestions were on the basis of cash, historical cost, modified historical cost, net assets at current value, businesses at current value or market capitalisation. It can be seen that by suggesting that the directors may want to consider making their own estimate of the current value of their whole business, this paper was trying to push

the debate regarding financial performance beyond the confines of the current financial statements. However, as long as it is thought that the financial statements can continuously be adapted as necessary, then it is unlikely that this debate will progress, and the financial statements' expectations gap may simply grow. The proposed treatment of intangible assets does not engage the debate at all merely reinforces the traditional position.

5.0 CONCLUDING COMMENTS

This paper has reflected upon the potential impact of IAS 38: Intangible Assets as a standard which is likely to be accepted, with only cosmetic changes, in both Australia and New Zealand, despite opposition from both academic and commercial positions.

The benefits of harmonising accounting standards can only be enjoyed when the standards themselves are capable of producing appropriate and consistent disclosures in accounting reports. IAS 38 is not such a standard because:

1. By prohibiting, without a good theoretical basis, those intangible assets which are generated internally, whilst requiring the inclusion of assets which have been purchased, IAS 38 will lead to inconsistency of treatment of like items.
2. By emphasising historical cost over other valuation techniques, IAS 38 conflicts with some conceptual frameworks, which are designed to at least allow for modification of the strict historical cost principle. These conceptual frameworks are intended to underpin, not undermine, the standard setting process. Furthermore, by insisting upon an active market for the determination of fair value, it is argued that IAS 38 will make the revaluation of intangible assets a difficult process.
3. By requiring the arbitrary amortisation of intangible assets, such as brand values (where these have been acquired externally) IAS 38 leads the balance sheet residuals to bear no resemblance to market values or estimated values in many cases.

However, the major impact and greatest danger from IAS 38 lies in the effect it may have on the development of relevant and useful disclosures by corporations (or on behalf of various stakeholder groups). This is not to suggest that the disclosure of internally generated intangible assets should be permitted in an uncontrolled and misleading manner, but that this information should be appropriately organised and controlled, and not simply prohibited.

The underlying problem may be associated with what Higson (1999) has described as the accounting expectations gap which is centered on the purpose of financial statements and accounting reports. If this is the case then the existing conceptual frameworks need to be revisited to clarify this purpose, so that standard setters are provided with a base upon which to build standards. In the case of IAS 38, however, there are indications that the standard has been prepared in line with the conceptual framework of standard setters from outside of Australasia, in which case the expectations gap is an international and not necessarily a national problem.

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