

The Myopia of Financial Accounting: What the Schizoid FASB Waiting for?

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ABSTRACT

The world is now moving towards a different era. Traditional financial accounting was designed to provide decision makers with information that is useful in assessing the performance of companies and how they are using economic resources efficiently. We are currently living under huge pressure on companies for innovation, research and recruiting the most valuable human resources. Financial statements are supposed to provide a true mirror of companies' activities and available resources. During the last two decades most companies moved towards knowledge based economy where investments in intangible assets such as human resources, information technology, and research & development have become more important than investment in fixed assets. In order to strength companies' competitive position and to increase investments in the area of intangible assets, accounting reports should provide information about these new areas that are drivers of business success. Unfortunately, conventional financial reporting appears to be rapidly less useful within today's dynamic business environment. It is difficult to manage which cannot be visualized. Improvement and increasing the usefulness of financial accounting is a long way and efforts done are not enough. What is needed? And how we can increase and mitigate with this problem? The aim of this paper is to address the problem of intellectual capital and trying to answer these questions as well as trying to highlight the consequences of the FASB delay in not acting to the problem?

1. Introduction

Accounting is generally considered as a measurement and communicating discipline. The wing of measurement relates to the assignment of numbers to events that are related to a certain company. Sometimes there are some problems to the measurement wing such as availability of

the data, lack of objectivity, uncertainty in the business environment and verifiability. The other wing which is the communicating wing relates to the presentation of financial information through accounting reports. To make financial information useful and meaningful, it should be prepared and presented in a standardized format (Belkaoui, 1994).

In a world without accounting standards, each firm would arrive at a custom-designed accounting and reporting system through negotiations among the participants. Markets cannot be relied upon to ensure that each firm, left to a direct negotiation among its own participating agents, shall arrive to an efficient accounting system. Managers have too much power and control over the accounting system and, unless this control is constrained by socially determined standards, inefficient accounting methods will be chosen (Sunder, 1997).

Many accounting regulatory bodies were established with the aim of regulation, setting objectives and harmonizing accounting standards around the world. The International Accounting Standards Committee (IASB, hereafter) is an accounting body with members of 143 professional accounting bodies in 104 countries. It is responsible for developing and approving International Accounting Standards by working closely with national standard setting bodies, securities regulatory agencies and stock exchanges in individual countries.

IASB recognized the growing importance of intangible assets in the last two decades from the past century and it has worked for almost 10 years to produce International Accounting Standard 38 (IAS38, hereafter) on intangible assets. IAS 38 applies to all intangible assets that are not specifically dealt with in other International Accounting Standards. The issuing of IAS 38 was controversial and raised debates between accounting academics, profession and individuals concerned about the financial information presented in financial statements and whether accounting can provide true picture about business activities. In the opinion of some “the

disharmony highlighted by the advent of IAS 38 could be a sign of the failure of international accounting harmonization” (Stolowy and Cazavan, 2001, p.477). Conventional accounting does not value intellectual capital as a resource of providing benefits to companies. In the special issue of Accounting Forum (2009), about financial accounting in the past, present and future, the editorial referred to accounting inertia and gives examples about the delay in the widespread adoption of double-entry bookkeeping which did not spread until the nineteenth century. Another example is the tendency of Eastern Europe to adapt old rules in preparing accounting legislation following the fall of USSR. The writer (2009, p.7) states:

Accounting inertia arises because of the reluctance of accountants to adopt new practices and ideas allied to their hesitancy in discarding old ones (Oldroyd, 1999). It imbues established practice with its own momentum, and has been observed many times before However, this resistance to change does not preclude discontinuities occurring in accounting practice that can have an acute effect on its future direction Thus, Walker (2000) cites a number of instances where crises have triggered accounting change.

The remainder of this article proceeds as follows. The next section explains some of the problems in financial reporting system. The third section presents an overview about intellectual capital dilemma and knowledge based economy. Finally the fourth section explores the accounting literature on intellectual capital exploring the consequences of the problem of intangible assets and the responsibility of FASB to act on the problem.

2. Problems in Financial Reporting System:

Many countries considered the importance of setting objectives to financial reports. The accounting profession in the United States, the United Kingdom, and Canada had made several

attempts to formulate the objectives of financial statements. The objectives and qualitative characteristics of financial reports are designed to make financial reports more clear and useful in helping users to take decisions (Belkaoui, 1994).

The importance of financial reports is very crucial for the users in today's corporate environment. They are looking for financial statements that can cope with the complexity of the new economy due to severe competition and technology advances of the company's businesses. In the past two hundred years, the neo-classical economic approach valued two factors only as drivers of production which are capital and labour. However, in today's world knowledge and information technology became the drivers of success. We are now living in information society in a knowledge economy.

The challenges facing financial statements in today's new economy are numerous and user needs are not satisfied. They are looking desperately for different sources of information to satisfy their needs (Kieso et al. 2004).

The IASC of the Institute of Chartered Accountants in England and Wales, the Financial Accounting Standards Board (FASB, hereafter) and accounting standard setters around the world nearly all have the same objectives of financial reports. For example, the Accounting Standard Board stated that the objective of financial reports is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users. The aim is to assess the stewardship of the entity's management and for making economic decisions.

There are different groups interested in the financial statements and they have diverse and conflicting needs of information. For example management of the company or governmental units needs a different kind of information than those demanded by shareholders or investors. As most people cannot obtain a purpose designed set of financial reports specific to their needs, the

reports should contain all the information that all users might possibly need. Despite this view, the FASB pointed that by satisfying the needs of investors it is highly probable that the needs of all users are satisfied. In the opinion of Levitt (1999, cited in Donohue and Howick, 2000, p.4) “Financial reporting is a language, just like German or English It is what people use every day to decide where to invest their hard-earned dollars”. By focusing on this point, without adequate financial information provided in financial statements, shareholders would be lost with insufficient information. They need information to judge financial performance of companies in order to be able to take economic decisions.

In theory, financial statements should be prepared according to user needs. Users need financial statements to facilitate decision making, monitoring managers and interpret contracts or agreements that include provision based on such information. The major recipients of financial statements are shareholders, investors, and stock market analysts. They need information to help in estimating growth prospectus in terms of share prices and dividend payments.

One of the principles that are used in the preparation of financial statements is historical cost principle. According to this principle assets are recorded at their cost. Historical cost is preferred because it is argued that it provide a relevant and reliable measure. Cost is relevant because it is a representative of the price paid, other asset sacrificed, or the commitment made on the date of acquisition. Cost is reliable because it is objectively measurable, factual and it can be verifiable. It is the result of exchange transaction with external party (Weygandt et al., 2002). Belkaoui (1994, p.236) criticizes the historical cost principle by stating that:

The precarious validity of the unit of measure postulate, which assumes that the purchasing power of the dollar is stable, is a major limitation to the application of the cost principle. Historical cost valuation may produce erroneous figures if changes in the values of

assets over time are ignored. Similarly, the values of assets acquired at different times over a period during which the purchasing power of the dollar is changing cannot be added together in the balance sheet and provide meaningful results.

Weygandt et al., (2002) criticize the historical cost principle as irrelevant. Prices are going up over time and the historical cost of an asset is not equivalent to market value or current value. Also, as the purchasing power of the dollar changes, so does the meaning associated with the dollar used as the basis of measurement. Consequently, accounting systems fail to keep its measurement wing.

Page (1992) argued that decision usefulness and historical cost cannot be complemented at the same time. The Accounting Standard Board objectives are foggy. By not mandating the use of current value accounting, they are not wholeheartedly pursuing a decision usefulness objective. Financial statements are merely providing a historical recording of transactions. Investors can use financial statements to show at best how the company is performing and, perhaps, gain some idea of expected future performance from it, but it is of limited usage to facilitate decision-making.

According to the Corporate Report issued (1975), if financial reports are to be useful and to fulfill their fundamental objectives they must possess some qualitative characteristics. The role of the qualitative characteristics is to ensure that the information in financial reports is valid to all users. The information must be relevant, reliable, complete, objective, understandable, timely and comparable (IASB, 1975).

Relevance and reliability are the main qualities. Relevance is the ability to influence the economic decisions of users. The relevance of particular information depends on the need of users and on the context in which the decisions are made. Relevant information has either

predictive or feedback value or both values. It also must be available to users before it loses its benefits to influence decisions and this relates to the timely basis as a qualitative characteristic. Reliability refers to the faithful representation of what information proposes to represent.

To be reliable, accounting information must be verifiable and being free from deliberate bias or material errors. It also cannot be selected or presented to favor some users over another. In some, it should be faithfully presented, neutral and verifiable in order to be reliable (Belkaoui, 1994).

Conflict may arise between relevance and reliability of information. The accuracy of past events reported in the financial statements by using historical cost is the crucial element of its reliability. However, a large amount of accounting information is based on professional judgment. One of the areas that creates problem between relevance and reliability is intangible assets. Because companies want to achieve reliability and to be conservative, some items are omitted from the financial statements (Rechtman, 2001). Donohue and Howick, (2000, p.6) state:

Bricks and mortar no longer constitute the core assets of a great fraction of corporate enterprise (Dyckman & Zeff, 1999/2000, p.90). In 1992 Coca-Cola's brand name- which does not appear in their financial reports- was valued at US \$ 25 Billion! (Ourusoff, Ozanian, Brown & Starr, 1992). Informational releases are becoming more important than financial statements. Company values in the stock market are increasingly based on their intellectual capital and brands rather than the tangible assets, which are valued on their balance sheet.

The ex-chair of the Financial Accounting Standard Board, Gene Flegm, argued for the favor of reliability over relevance of information to decision makers. In his opinion historical cost is the only value that should be used; any other value will be unreliable and cannot be relied upon. In the same venue, Arther Levitt, who was the Chairman of the Security of Exchange

Commission in USA argued for strong control over the information provided in financial statements to remove the flexibility and choices of accounting practices from the US accounting system (Lundholum, 1999).

As shown from the discussion in this section, there is a conflict between relevance and reliability and there must be a balance between them in order to provide financial statements that are useful to decision makers. Wyatt and Abernethy (2003, p.3) state:

Accounting academics, regulators and other major stockholders are grappling with the trade-off between the relevance of external financial reports and maintaining the reliability and verifiability of the information provided Regulators are faced with a conundrum. They want to promote public interest and investor confidence by ensuring that financial reports are based on verifiable data. On the other hand, they want they want to encourage financial reporting that is informative to stakeholders and promotes efficient resource allocation.

As we have problems in the measuring wing of financial reporting, we also have problems in the communication wings by having financial statements not harmonizing with knowledge based economy and under accountants manipulation. The problem of current financial reporting system is that we are trying to visualize new phenomenon using an out of date lens. As stated by Sveiby (2010, p.1):

The main problem with measurement systems is that it is not possible to measure social phenomena with anything close to scientific accuracy. All measurement systems, including traditional accounting, have to rely on proxies, such as dollars, Euros, and indicators that are

far removed from the actual event or action that caused the phenomenon. This creates a basic inconsistency between managers' expectations, the promises made by the method developers and what the system can actually achieve and make all these systems very fragile and open to manipulation.

Fraudulent financial statement became a habit where every year the public witnessed spectacular business failures. The lost in confidence and trust undermined auditor's credibility and the public accuse the accounting and auditing profession. So coupling problems in measuring and communication together with fraudulent financial statement, we will have a recipe of complete disaster. As pointed by Adkins (2009, page 1):

Financial statements manipulation is an ongoing problem in corporate America. Although the Securities and Exchange Commission (SEC) has taken many steps to mitigate this type of corporate malfeasance, the structure of management incentives, the enormous latitude afforded by the Generally Accepted Accounting Principles (GAAP) and the ever-present conflict of interest between the independent auditor and the corporate client continuous to provide the perfect environment for such activity. Investors how purchase individual stocks or bonds must be aware of the issues, warning signs and the tools that are at their disposal in order to mitigate the adverse implications of these problems.

To build a concrete conceptual framework for financial reporting, it is necessary to lay fundamentals which include objectives and qualitative characteristics of accounting information. Sometimes conflict exists between the qualitative characteristics; there are problems in the objectives of financial reports and manipulation of financial statements. Until these defects are corrected, financial reports will not be able to play the role assigned to it. As social, political, and

economic contexts change, accounting academics and standards setting boards need to decide on qualitative characteristics that encourage the objectives of different financial reporting system. The problems of financial reporting together with the dilemma of intangible assets accelerate to form the myopia of financial accounting. while the former was the concern of this section, the later will be the focus of next section.

3. Intangible Assets Dilemma and Knowledge Based Economy:

Traditionally, tangible resources and physical capital were the most important factors in achieving competitive advantage. Tangible assets used to provide high volume products to maximize profits. Currently, with the movement to knowledge based economy, companies are less attracted to tangible resources and more concerned about knowledge, information technology, research and development, innovation, and customer loyalty. All of previous factors represent pillars of success in the new economy (Ali et al., 2012). Accounting academics has been discussing the topic of intangible assets and how to report it in the financial reports for a long time. However during the last two decades of the past century, more emphasis has been given to the topic. Many differences exist between countries on dealing with the topic and with today's globalization and internalization of markets serious problems occur in the comparability of financial reports in the international context (Stolowy and Cazavan, 2001).

Foster et al. (2003) argued that many companies stockholders equity per share has been significantly lower than the price per share as traded on the stock market. For example, Microsoft reported stockholders equity of about \$ 68 billion in recent financial statements, although its market value at the filing date was approximately four times that amount. The difference in these values is related to the failure of the current financial reporting model to

report the values of certain intangible assets. The balance sheets of some companies do not reflect their true worth. Lindsey (2001) pointed out that during eighties and nineteen's the book value was providing 95% of market value of public companies however recently this percent dropped to nearly 30% which is nearly consistent with Foster et al., (2003) study.

Parker (2000, p.60, cited at Donohue and Howick, 2000, p.6) states that “what use are financial reports that only report on a fraction of the company’s market worth?”. According to Weygandt et al., (2002) King World’s most valuable asset is the right to license television shows such as “The Oprah Winfrey Show”. Almost 88 percent of its \$ 683.8 million in 1998 came from the fees associated with the rights to licenses on these intangible assets.

The prominence of the problem of intangible assets in the past few decades is due to changes in the way business world operate. Intangible assets became very crucial and represent a large portion of company’s assets in the information age. Business companies even the traditional manufacturing companies are moving towards an information edge where competition is based on intangible resources other than fixed and liquid assets (Rechtman, 2001). It is now commonly accepted that we are living in a world of intangible or knowledge economy and this is the environment companies have to learn to cope with. Especially in the last two decades most industrial countries have moved towards a knowledge-based rapidly changing economy where investments in human resources, information technology, and research and development have become essential in securing the competitive position of the company in the market. Economic growth today is not as much influenced by investments in fixed assets as by knowledge. Zambon (2002, p.6) states:

Unfortunately conventional accounting systems still largely to concentrate on and to measure only the value of financial and physical assets-plant, equipment, inventories, land and natural resources. In other hand, conventional accounting principles simply do not account for many drivers of corporate success in knowledge based economy, e.g. investments in intangible assets such as know-how, brands, patents and customer loyalty. There presently exist no adequate accounting techniques for determining and reporting the value of intangible assets such as the skills of workers, IP, business infrastructure, brand names, databases and relationships with customers and suppliers.

In general measuring intangible assets is dumping for historical cost principle. The generally accepted accounting principles (GAAP, hereafter) require that cost to guide any valuation. This requirement is a response to GAAP frame-work of conservatism. However, when intangible assets are appraised in value it becomes forward-looking measurement which is inconsistent with the nature of financial reports which provide a backward-looking to past events. Estimating future values create problems to the reliability of financial reports (Rechtman, 2001). In the same vein Ali et al., (2012, p.2695) stated that:

According to Theory of Intellectual Capital, the difference between market value and book value is known as hidden value. This hidden value regards to the intangible assets which is translated as intellectual capital of company which is not been reported in the financial statements (Soler & Celestino, 2007). Although intellectual capital was not been quantified in the financial statement presentation, it contain high capacity to differentiate companies against competitors and gives competitive advantage in the future.

Traditional financial accounting assumed to perform reasonably well when companies invest in physical assets. However, it does not perform so well when companies increase their investment in innovation and inventing new products. It is difficult for investors and accountants to value this additional investment because the future earnings generated are uncertain. Traditional accounting finds it practically difficult to cope with the rapid innovation which is driven by investment in intangibles (Zambon, 2002). In the atmosphere of Enron collapse, Lev (2003, p.18) uses the testimony of Federal Reserve Chairman Alan Greenspan in February 2002, to agree for the problems in intangible assets by stating that “physical assets retain a good portion of their value even if the reputation of management is destroyed, while intangible assets may lose value rapidly”.

Foster et al. (2003) pointed to this problem by arguing that intangible assets of many high tech companies “walk out of the door every night”. In late 1999, ASK Jeeves company common stock sold as \$ 180 per share. Less than 18 months later, the stock sold for about \$ 1 per share. Apparently some of the company’s assets that “walk out of the door every night” failed to return next morning. The criticism of current financial reporting is based on the ground that balance sheet should provide a true value about companies assets. However, accountants and shareholders increasingly recognize that the book value of a particular asset on a balance sheet may have little relation to the actual value of that asset. Lev (2003, p.17, emphasis added) pointed to the problem by stating that:

Intangible assets are both large and important. However, current financial statements provide very little information about these assets. Even worse, much of the information that is provided is partial, inconsistent, and confusing, leading to significant costs to companies, to

investors, and to society as a whole. Solving this problem will require on –balance- sheet accounting for many of these assets as well as additional financial disclosure. These gains can be achieved, but only if users of financial information insist upon improvements to corporate reporting.

Accounting professional bodies recognized the problems in financial reports and they tried to issue accounting standards to overcome this problem. Is their effort sufficient or not? This will be the concern of the next section of this article.

4. Accounting for Intellectual Capital and FASB Reluctant of Full Action:

Traditional financial accounting and reporting practices provide basis for evaluating company's business performance. The basic objective of financial accounting is to provide users of financial reports with useful information to help them in utilizing scarce resources and to take effective decisions. The omission of some items from financial reports makes conventional financial statements to become less useful in today's business environment. Foster et al. (2003, p.1) state:

Recently issued accounting standards have created the need for valuation of intangible assets for financial statements purposes. Arriving at these valuations can be complicated and uncertain process. Although the standards address only those intangibles acquired in business combination, they raise the question of what values remain hidden within internally developed intangibles.

The United States FASB issued SFAS 141 for intangible assets acquired in business combinations. It also issued SFAS 142 for goodwill and other intangible assets following their acquisition. However, neither standard deals with the problem of internally developed intangible

assets. The IASC in trying to carry its responsibilities to face the problems hindering the efforts of the accounting profession issued, in October 1998, International Accounting Standards 38 (IAS 38, hereafter) on intangible assets. It has been considered “highly conservative, with the exceptional issue of two exposure drafts” (Stolowy and Cazavan, 2001, p.478). The IAS 38 was controversial during the development phase due to the lack of consensus on the importance and methods used for accounting for intangible assets. It is also controversial as it excludes most internally generated intangible assets from the balance sheet. It includes advertising, training, start-up, and research & development activities. For intangibles to be recognized as assets, they are required to meet definitions spelled out in the standard, generate a flow of benefits that are likely to accrue to the company, and are able to be measured reliably. Although this places businesses under the obligation of recording intangible assets on the balance sheet, it does impose strict conditions on the capitalization of such assets in order to get greater certainty on their future benefits. This condition limits the applicability of the standard in measuring and valuing a number of intangible assets (Zambon, 2002). Flegm (2006, p.2) states:

Oddly enough, FASB has ignored modifying SFAS 2 (R&D), under which all expenditures are expensed immediately. Companies spend billions of dollars on R&D. However, unless the managers are stupid, there must be some future value derived from the expenditures. Of course, the difficulty involved in determining that future value led to the very conservative position (once a basic tenet of accountants) of writing off the expenditures in the year made.

IAS 38 states that an intangible asset should be recognized if and only if (a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and (b) the cost of the asset can be measured reliably. If an intangible does not meet both the definition of and the criteria for recognition as an intangible asset, IAS requires the expenditure

of this item. The IASC includes a list of intangible items which fail the recognition criteria which are internally generated goodwill, brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognized as assets (IASB, 1998).

Wyatt and Abernethy (2003) argued that most jurisdictions make asset recognition criteria to depend on the existence of a verifiable past cost. However, historical cost will not always lead to a balance of relevance and reliability. For example, some relevant intangible assets do not have a clearly identifiable historical cost such as patents developed over a long period of time. The defects of historical cost measurement have been recognized in other contexts such as financial instruments and assets revaluation but not in the intangibles context. In sum historical cost is problematic as it reflects past transactions but do provide very little information about the existence and realizability of future benefits. They state (p.11):

In summary, because a “cost” exists from a transaction with an external party, the accounting measurement and recognition issues associated with acquired intangible assets are less controversial than those attending internally generated intangible assets. Realistically however, this is illusory because obtaining fair values for acquired intangibles involves the very same forecasting uncertainties as internally generated intangible assets.

The FASB announced SFAS 141 and 142 to be effective for fiscal years beginning after December 15, 2001. SFAS 141 requires an acquiring entity to allocate the purchase price of an acquired entity to the assets acquired and liabilities assumed at their estimated fair values on the date of acquisition. It requires a separate recognition of intangible assets from purchased goodwill if it arises from contractual or other legal rights. Once the acquisition cost has been allocated to acquired assets including intangibles and assumed liabilities, any remaining amount is recognized as goodwill. SFAS 141 also replaces the choice of either pooling or purchase

method of accounting for business combination with a requirement for firms to use the purchase method. Woodward (2003) argued that despite certain criteria had to be met to use pooling accounting, the practice was dominated. With SFAS 141 all business combinations are required to use purchase method. This is considered as step forward in the recognition of intangible assets as the acquiring company is required to identify and fair value all the assets acquired irrespective of whether they are shown in the target's financial statements whereas pooling accounting simply requires the balance sheets of the combining companies to be added together. Zambon (2002, p.11) states:

The FASB is concerned that pooling obscures the true cost of acquisitions. Companies have to break down goodwill into its component elements (i.e., intangibles), which will be no more amortized, but subject annually to an impairment test aimed to verify whether the value of these intangibles has decreased.

SFAS 142 requires companies to conduct at least once a year test for impairment of goodwill. Under the new standard goodwill will have indefinite life and instead of amortization, it is reviewed for impairment at least once a year. Other intangible assets may have definite lives such as trademarks. Most intangible assets, however, will be amortized over their expected useful lives. Management therefore has additional task to determine the expected useful life of the assets acquired. The standard permits the use of straight-line method for amortization (Foster et al. 2003, Woodward, 2003).

Although there are some achievements in the area of intangible assets, problems still exist. As noted by Woodward (2003) some similarities and key differences exist between IAS 38

and SFAS 141 and 142. However, the problem of internally generated intangible assets represents a rock on the road of accounting standardization. She states (2003, p.4):

At the present time the US accounting are the most comprehensive and onerous in the area of accounting for intangible assets and are only applicable to US companies and those non-US companies who have US registrations Unfortunately there are still likely to be differences between IAS and US accounting standards True transparency will not however be achieved until the accounting standard setters permit internally generated intangible assets to be recognized.

In the same vein Blaug and Lekhi (2009) pointed in their report to the problems in reporting intangible assets and blame accounting standard setting bodies for not actually trying to solve the problem correctly. They state (P.4):

Despite decades of debate and effort, it has not proved possible to find a way of accounting for such assets in the same way as, say, investment in a machine. This is what we call in this report the "value paradox"- recognizing the value of such assets but being unable to account for them through conventional accounting rules ... The primary focus must be on improved company reporting of intangibles in a more consistent and comprehensive way: whatever the theoretical benefits of changes to accountancy practice, efforts to find practical way forward have not proved successful.

The following section is concerned about the consequences of the mismeasurement of intangible assets and the further research needed in the area.

5. Consequences and Solutions to the Problem of Intangible Assets

The traditional approaches to determine the value of companies requires the use of accounting information derived from tangible assets. However, these methods do not take into consideration the significance of intangible assets held by companies. Examples of these intangible assets are customer relationships and well trained workforce. The market values of firms typically far exceed book values. Accounting reports became less useful and nearly lost its relevance. Accounting measures is not adequate as a base for strategic management of the firm. Growth of companies depends not only on physical resources available but also on how many intangibles create values from out these tangible resources. The lack of information on intangibles, creates problems in evaluating companies and investing in it. This problems touches many stakeholders such as investors, management and creditors. Within the traditional accounting framework "we know intangibles are valuable, but cannot say how" (Blaug and Lekhi, 2009, p.7). Information asymmetry exist between managers and investors leading to a more insiders gains as a consequence of the failure or unwillingness of the regulatory accounting bodies to develop a suitable architecture of financial accounting reporting system. Lev et al., (2005, p.46) sums the consequences by stating that:

The lack of information has harmful for both firms and investors as they might lead to higher cost of capital and interest rates, greater uncertainty of earnings, and greater errors in earning forecasts Identifying, measuring and reporting internally generated intangibles, and assets acquired in a business combination, is causing a serious problem for accounting.

The problem increased when companies, especially in today's knowledge based economy, heavily invested in intangible assets (Lev, 2004). Zambon (2002, p.8) states:

There is considerable evidence that this lack of information about assets and true sources of value in corporations is already an urgent problem for corporate investors and managers. However, because valuation and disclosure issues related to intangibles are complex and little understood, accounting standard-setters around the world encounter great difficulties in attempting to improve disclosures about intangible assets.

Foster et al. (2003) argued that the criticism to financial reporting is due to the expectation that the balance sheet should convey the value of the company's assets. The FASB and IASC tried to encounter the problem of intangible assets and solve it by issuing SFAS 141, 142 and IAS 38 but the problem still exists. They state (p.3):

The balance sheet undoubtedly has significant limitations in terms of reporting an entity's true value. Internally developed intangible assets, even those for which a fair value may be determinable, are not recognized in the financial statements. Other intangible assets, such as political clout and regulatory expertise, are generally not even discussed in company reports. Investors and creditors recognize these limitations, and presumably perform independent research and analysis in their investment and credit decisions. The two recent FASB standards do little, if anything, to help investors better evaluates this aspect of businesses.

Lev (2003, 2004) argued that SFAS mandates the capitalization of software development costs. Many software companies are not following the rule like Microsoft while some less profitable companies tend to capitalize significant amounts of software development. So some

companies are following the rules while others are not and thus there are many difficulties for outsiders to rely on financial statements. He conducted a study with Paul Zarowin to estimate the information content of earnings announcements and the change in stock prices around the time of announcements and found little impact on investor's decisions. Also the firms with significant changes in R&D spending are the ones for which the information deteriorations is the worst. Managers are looking for alternative measures of performance such as balanced scorecard where non-financial measures of performance can be added to financial measures. Investors also undervalue companies with significant R&D as financial statements contain very little information about them. As a consequence managers invest less in R&D. Several studies showed that investment of R&D in the U.S is half the optimal level which can create serious social consequences. Information asymmetry exists to insiders in R&D companies. Seveiby (2010, p.1) pointed to case of Shell company in which managers overstate oil reserves by 4.4 billion barrels which represent 23% of the total reserves. He stated that:

Oil and gas reserves cannot be measured exactly since estimation of reserves involves subjective judgment. If this can happen with physical resources, what did you suspect can happen with valuing intangible assets? Is your company immune? If this could happen in Shell, what do you imagine might going on in your company? The traditional accounting system that is heavily regulated by governing bodies and audit and with heavy penalties imposed on offenders suffers from regular manipulation. Imagine the abuse an intangibles measurement system is open to; there is no standard, no audit and it is voluntary only.

Aboody and Lev (2000) conducted a study to measure gains to insiders. They found in R&D intensive firms that the gains to insiders are four times to other firms and the reason for this is the information asymmetry. Zambon (2001, p.11) highlighted the difficulties to the problems of intangible assets and pointed to the solution by stating that:

Unfortunately, accounting for intangible assets is more easily described than implemented. It is a new discipline, as yet largely underdeveloped As a result of the numerous problems associated with traditional financial measures of intangible assets- there is a general agreement that new types of measurement system are needed that will help investors, managers and policy-makers alike manage more effectively in the knowledge economy.

According to Lev (2003) to deal with the problem of financial reporting in the area of intangible assets, it is necessary to increase recognition and the level of disclosure in financial statements. He proposes a comprehensive balance sheet so that investors can have clear information about the company. New measurement systems are needed that will help accountants to provide useful information to users of financial statements so that they can respond to challenges in today's knowledge based economy.

Stolowy and Cazavan (2001) conducted a study to examine the ways that 21 countries approach the topic of intangibles in terms of definition and treatment. The results show lack of overall homogeneity in dealing with intangibles and no generally accepted conceptual framework exists. Many countries do not implement one treatment for each type of intangibles. In searching for solutions, they state (p.499):

All the efforts to attain global harmonization could result in failure, in particular because of IAS 38 which is in opposition to the treatments adopted in several countries may be it is worth while thinking about other ways of making accounting comparable in the meantime for example by providing additional information in the notes. One possibility is the disclosure of an additional statement of the breakdown, changes and values for the most important groups of intangible assets in a corporation.

We are as accounting and finance academics and professionals in a middle of a crises. Accounting should provide information about financial position and financial performance of companies. It must provide information that can help stakeholders to assess companies and make decisions. However, accounting is not able to perform its function. It needs a revolution not just corrections or presenting a new accounting standard. What was suitable in the old context, is no longer satisfying user needs. The change starting from conceptual framework to the contents of financial statements are inevitable , if we are looking to preserve the statues of our discipline. With the current situation of financial accounting, we can no longer be comfortable when we teach our students that accounting is an information system that is provides information for decision-making

6. Conclusions:

It is now commonly accepted that we are living in an era of knowledge economy. This new context requires companies to cope with its environment and to learn how to correct its path in order to be able to survive and overcome problems. Accounting for intangible assets is one area that creates problem to corporations. Financial accounting has traditionally provided basis

for evaluating company's business performance. The fundamental objective of financial accounting is to provide users of financial statements with useful information for the purpose of efficient and effective decision making. By the failure to provide accurate and reliable information regarding intangible assets, accounting systems are in jeopardy. It is necessary to re-evaluate the conceptual framework of accounting as well as to close the information gap between what is currently presented in the financial statements and what should be presented to make financial statements more useful to decision makers. The accounting standards issued recently (SFAS 141, 142 and IAS 38) tried to solve the problem of intangible assets. However there is still a big problem concerning internally developed intangible assets. Intangible assets are increasing rapidly and constitute a very big portion in our new economy. Unless accounting regulators, academics and accountants deal with this problem firmly, accounting will no longer have its relevance as a source of information.

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