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## The Relevance of Intangible Assets in the Knowledge-Based Industry

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Ardana, C.I., Dermawan S.E., Widjaja I.D.\*)

**Abstract:**

*The abundance of intangible assets that are not recognized as assets and only fall under the expenses category according to the existing financial accounting standards (the existing FAS) and the impact of such practices, justify this research and further developments.*

*Many stakeholders are not satisfied by this accounting treatment. They require the expenditure for intangible assets to be treated as investments (assets), and not as expenses. The purpose of this study is to assess the effectiveness of the existing FAS, and then try to provide an alternative (the modified FAS) aimed at enhancing the degree of relevance of financial statements relating to intangible assets.*

*The modified FAS tries to accommodate the expectations of stakeholders using such information. This is a case study research using secondary data from two companies listed with the Indonesia Stock Exchange during the 2014-2016 time frame. By comparing two versions of financial figures and ratios (using the existing FAS and the modified FAS), it can be concluded that (a) total assets and operating profits using the modified FAS are higher than those in the existing FAS; (b) profitability ratios (OPM, ROA, ROE), and leverage ratios (DTA, DER) in the modified FAS are better and healthier, but asset turnovers (ATO) are lower than those in the existing FAS.*

*The higher the variation of the financial figures or ratios between the two versions of FAS, the lower the relevance of the financial statements. The relevance of the statements will improve if the authorized body accommodates the expectation of the users of financial statements.*

**Keywords:** *The modified FAS, case study.*

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### 1. Introduction

The value of corporations in today's global economic system and in the coming years will be characterized by an increasing role of investment under the form of intellectual capital/IC (Smalt and McComb II, 2016:1; Zeghal and Maaloul, 2011:262). Another term often used for the IC is "knowledge capital" but from an



accounting perspective, the term intangible assets is more popular to describe this kind of assets (Ancuta, Moisescu, and Varlanuta, 2017:32). As said by Vetrenko, Mordovets, and Yaluner (2017:605), the main tool for the IC development is an "intelligent enterprise", which is described by a permanent education process. The interesting question is why accountants cannot (will not) recognize most of the value of this intellectual capital in the corporate balance, whereas the contribution of intellectual capital has an increasingly important role in determining the value of a corporation. Aiming to answer this question, this study will attempt to examine the different views on intellectual capital from two perspectives: users of financial statements (business people, economists, investors), and presenters of financial statements (accountants), and try to provide an alternative view aligning these two different perspectives. To clarify this issue, this research presents two versions of selected financial figures and ratios, using the existing FAS and the modified one, from two public companies listed with the Indonesia Stock Exchange in of 2014-2016.

## **2. Literature Review**

Damodaran (2009:3) saw inconsistent accounting treatment of the expenditures relating to the acquisition of tangible assets with intangible assets, particularly in distinguishing two types of expenditures - whether an expenditure is called capital expenditure or operating expense. The simple basic principle or rule used by the accountant to distinguish these two types of expenditure is to look at the economic benefits of the expenditure. If the impact of the benefit is longer than one year, it will be recognized as a capital expenditure, but if its impact is only during the current year, it is recognized as an operating expense. This rule applies consistently to tangible fixed assets (land, buildings, equipment, vehicles), but not to intangible assets. Most expenditures related to intangible assets are recorded as operating expenses, even though they have an economic impact for more than one year.

Koch et al (2000:6) suggested that intangible assets play an increasingly important role in the creation of corporate value; however, using a traditional accounting mechanism in recognizing assets is no longer sufficient in the knowledge-based economy. Salamudin et al (2010:391) reveals that the book value of net assets (BVNA) is still dominant in Malaysian corporate valuation but this trend is declining as greater interest has now been directed towards employing intangible assets and earnings as important variables and the results indicate that there is a positive trend for intangible assets development in Malaysia. This is consistent with those of advanced markets such as the US, Europe and Australia, but the Malaysian market lags by about 20 years as compared to the more advanced ones. The main contribution of their study provides empirical evidence that intangible assets or intellectual assets are strategic assets that require attention in line with development of the knowledge-based economy.



According to the IAS no 38 on intangible assets (Mirza and Holt, 2011: 393), any resource usage or expenditure, especially from internally generated programs, can be recognized as intangible assets (or to be capitalized) only if it generates a certain impact for the company's future benefits, but if its impact for the company's future benefits is still uncertain, it must be treated as expenses. By applying this strict rule, most expenditure relating to internally generated intangible assets will be recorded as expenses, and not as assets. Consequently, both profit figures in profits and losses summary and asset value in balance sheets are understated. Expenditures for research and development, customer related activities, promotion, product and IT development, human resource training and similar, are still treated as expenses by accountants, based on the fact that all these kinds of expenditure are still uncertain. Meanwhile, most users of the financial statements consider that all these kinds of expenditure are clearly meant for the future growth of a company and, consequently, they must be treated as assets. Currently, there is a trend, according to which, more and more researchers and users of financial statements demand that existing FAS to be modified.

As mentioned by Damodaran (2009:2), accountants routinely miscategorize operating and capital expenses when firms invest in intangible assets. Accountants treat fixed assets and intangible assets differently. In fixed assets, any expenditure that generates economic impact for longer than one year is capitalized as asset, but in case of intangible assets, most of the expenditure that qualifies as capital expenditure is still to be treated as expense. The inequality in accounting treatment between fixed assets and intangible assets may obscure the consistency of account presentation in financial statements.

### **3. Hypotheses**

Criticism of the weakness in the presentation of financial statements from a semantic perspective has been widely approached in accounting theory books. While this is not responsibly treated by the authorized body (IAI/IASB), the public is increasingly questioning the figures in the financial statements. If the financial accounting standard only focuses on the syntactic order alone, then, this could have an impact on losing public confidence in the accounting profession, and, in turn, on eroding the relevance of the statements for decision making.

### **4. Research Methodes**

This research uses a case study method. Two knowledge-based public companies selected as research subjects are PT GIAA and PT INDF. The financial statements of both companies were used as objects of study. There are two variables in this case study model: first, the relevance of financial statements, and second, the existing FAS, which is guided by the International Accounting Standard (IAS) No. 38 on intangible assets. Data collection for the case study in this research has been based on observation and documentation.



## 5. Result and Discussion

In order to increase the relevance of the statements, in the respect of improving the semantic order of the statements, this research tries to propose a modified FAS by accomodating most (if not all) views of users relating to intangible assets. Under this modified FAS, the "certainty" criteria is to be softened. The reason is that it is impossible to predict with a high degree of certainty during an early stage, the future benefit of any expenditure of internally generated intangible assets. Although they are uncertain, all these kinds of expenditure will clearly influence the future growth of a company. For this very reason, any kind of expenditure of intangible assets can be capitalized first. In fact, the modified FAS is identical to the accounting treatment of goodwill where no amortization is recognized, and periodically it is subject to an impairment test. When the result of the impairment test is significant, it is then recognized as a loss of impairment.

Using PT GIAA and PT INDF during 2014-2016 time interval as a case study, some financial figures and ratios under the two versions of FAS (the existing, and the modified FAS) can be summarized in Table 1 and Table 2.

**Table 1.** Comparative accounts using the existing FAS and the alternative (modified FAS) 2014- 2016

| Description              | PT GIAA (in USD)           |                  | PT INDF (in Rp.000.000,-)  |                  |
|--------------------------|----------------------------|------------------|----------------------------|------------------|
|                          | The existing FAS (PSAK 19) | The modified FAS | The existing FAS (PSAK 19) | The modified FAS |
| Operating Income (2014)  | (395.228.121)              | (328.879.517)    | 7.319.620                  | 8.755.741        |
| Intangible Assets (2014) | 6.017.329                  | 72.365.933       | 2.761.473                  | 4.197.594        |
| Total Assets (2014)      | 3.113.079.315              | 3.179.427.919    | 86.077.251                 | 87.513.372       |
| Total Equity (2014)      | 879.467.591                | 945.816.195      | 40.274.198                 | 41.710.319       |
| Operating Income (2015)  | 168.745.441                | 274.865.050      | 7.362.895                  | 10.349.064       |
| Intangible Assets (2015) | 4.648.523                  | 110.768.132      | 2.628.235                  | 5.614.404        |
| Total Assets (2015)      | 3.310.010.986              | 3.416.130.595    | 91.831.526                 | 94.817.695       |
| Total Equity (2015)      | 950.723.185                | 1.056.842.794    | 43.121.593                 | 46.107.762       |
| Operating Income (2016)  | 99.103.939                 | 231.903.047      | 8.285.007                  | 12.999.911       |
| Intangible Assets (2016) | 4.992.892                  | 137.792.000      | 2.329.997                  | 7.044.901        |
| Total Assets             | 3.737.569.390              | 3.870.368.498    | 82.174.515                 | 86.889.419       |



|                     |               |               |            |            |
|---------------------|---------------|---------------|------------|------------|
| (2016)              |               |               |            |            |
| Total Equity (2016) | 1.009.897.219 | 1.142.696.327 | 43.941.423 | 48.656.327 |

*Source: Financial statements as reported with the Indonesia Stock Exchange.*

By reclassifying promotional expenses, professional services and training expenses of PT GIAA amounting to USD. 26.679.499 in 2016, USD. 39.771.005 in 2015, and USD. 66.348.604 in 2014 as accumulated addition in intangible assets, and reclassifying advertising and promotional expenses and expert services of PT INDF totaling Rp.1.728.735, - in 2016, Rp.1.550.048, - in 2015 and Rp.1.436.121 in 2014 as accumulated addition in intangible assets will significantly change the operating income, intangible assets, total assets, and total equity of both companies. Some key ratios affected by the modified FAS are: Operating Profit Margin (OPM), Return on Assets (ROA), Return on Equity (ROE), Debt to Asset Ratio (DTA), Debt to Equity Ratio (DER), and Asset Turn Over (ATO). Table 2 below shows the changes in those ratios.

**Table 2. Changes in Financial Ratios 2014 through 2016**

|         | 2016                              |                  | 2015                              |                  | 2014                              |                  |
|---------|-----------------------------------|------------------|-----------------------------------|------------------|-----------------------------------|------------------|
|         | The Existing FAS (PSAK 19/IAS 38) | The modified FAS | The Existing FAS (PSAK 19/IAS 38) | The modified FAS | The Existing FAS (PSAK 19/IAS 38) | The modified FAS |
| PT GIAA |                                   |                  |                                   |                  |                                   |                  |
| OPM     | 2,56%                             | 6,00%            | 4,42%                             | 7,2%             | -10,05%                           | -8,36%           |
| ROA     | 2,65%                             | 5,99%            | 5,10%                             | 8,05%            | -10,58%                           | -10,34%          |
| ROE     | 9,81%                             | 20,29%           | 17,75%                            | 26,01%           | -44,94%                           | -34,77%          |
| DTA     | 72,98%                            | 70,48%           | 71,28%                            | 69,06%           | 71,75%                            | 70,25%           |
| DER     | 270,0%                            | 238,70%          | 248,2%                            | 223,24%          | 254,0%                            | 236,2%           |
| ATO     | 103,3%                            | 99,83%           | 115,3%                            | 111,67%          | 126,4%                            | 123,7%           |
| PT INDF |                                   |                  |                                   |                  |                                   |                  |
| OPM     | 12.41%                            | 19.48%           | 11.49%                            | 16.15%           | 11.51%                            | 13.77%           |
| ROA     | 10.08%                            | 14.96%           | 8.02%                             | 10.91%           | 8.5%                              | 10.00%           |
| ROE     | 18.85%                            | 26.71%           | 17.07%                            | 22.45%           | 18.17%                            | 20.99%           |
| DTA     | 46.53%                            | 44.00%           | 53.04%                            | 51.37%           | 53.21%                            | 52.34%           |
| DER     | 87.01%                            | 78.58%           | 112.96%                           | 105.64%          | 113.72%                           | 105.81 %         |
| ATO     | 81.23%                            | 76.82%           | 69.76%                            | 67.56%           | 73.88%                            | 72.67%           |

*Source: Financial statements as reported with the Indonesia Stock Exchange.*

With modified FAS, the profitability ratios (OPM, ROA, ROE), and the leverage ratios (DTA, DER) are better and healthier, but the asset turnover (ATO) is lower than those in the existing FAS. Most variations in financial figures and ratios between the two versions of FAS are significant. The wider the variation of the



financial figures or ratios between the two versions of FAS, the lower the relevance of the financial statements. The relevance of the statements will continue to be questioned if the authorized body does not accommodate the needs of the users of financial statements.

## 6. Conclusion

The existing FAS (IAS 38), relating to intangible assets, applies a strict rule to capitalize any resource usage or expenditure, especially from internally generated activities. The expenditure can be capitalized only if it generates a certain impact for the company's future benefits, but if the impact for the company's future benefits is still uncertain, it must be treated as expense. By applying this strict rule, then most expenditure relating to internally generated intangible assets will be recorded as expenses, and not as assets. Consequently, both profit figures in profits and losses summary and asset value in balance sheet are understated.

This research proposes a modified FAS aimed at increasing the relevance of the statements, in the respect of improving the semantic order of the statements. Within the analysis of financial statements of the two knowledge-based public companies listed with BEI during the 2014-2016 time interval, the profitability ratios (OPM, ROA, ROE), and the leverage ratios (DTA, DER) in modified FAS are better and healthier, but the asset turnovers (ATO) are lower than those in an existing FAS. The constraint of this study is that the published financial statements do not display detailed expenditure, so that the analysis in this study is limited to the information disclosed in the notes to the financial statements.

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