

THE PRACTICE OF FAIR VALUE ACCOUNTING FOR INTANGIBLE ASSETS IN BULGARIAN ENTERPRISES

sen. ass. Iva Moneva
VFU “Chernorizets Hrabar”

sen. ass. Nikolina Grozeva
VFU “Chernorizets Hrabar”

Abstract

Bulgarian enterprises apply International Accounting Standards or National Accounting Standards for small and middle enterprises as accounting basis. The intangible assets can be recognized and presented in financial statements at their fair value according to applicable accounting standards. In this paper we investigate the problems, arising for Bulgarian accountants, related to accounting for intangibles and their fair value estimation.

Key words: *fair value, intangible assets, IAS/IFRS, NFRS for SME*

Jel Classification: M41 Accounting

Introduction

Companies in Bulgaria apply International Accounting Standards/International Financial Reporting Standards (IAS/IFRS) or National Financial Reporting Standards for SME (NFRS for SME) as a basis of accounting. Under the applicable standards intangible assets can be recognized in the financial statements of the enterprise at their fair value. In this paper, we present some issues related to reporting intangible assets at fair value and the problems that arise in this connection to the accounting profession in Bulgaria.

Today it is very difficult to assess the role of intangible assets in modern economy. The first economic studies that analyze objects later charged in the intangible assets are made at the end of the 19th century. Initially the rules for accounting of intangibles were developed from IASB with adoption of IAS 9 Accounting for Research and Development Activities, superseded by IAS 38 Intangible assets in 1999.

In Bulgarian literature and practice, the concept of intangible assets was brought into use after the change of the economic and political system at the end of 1989. The initial regulations of the concept were not sufficiently clear and concrete. Now, accounting of intangible assets in Bulgaria and their presentation in the financial statements of companies is based on the following basic regulations:

1. Bulgarian Accountancy Act;
2. National Financial Reporting Standards for Small and Medium Enterprises (NFRS for SME);
3. International Accounting Standards/ International Financial Reporting Standards (IAS/IFRS).

Accountancy Act governs the accounting requirements for comprehensiveness and reliability of accounting systems (accounting) in enterprises, the content, preparation and publicity of the financial statements of enterprises as well as the requirements for those who prepare financial statements.

NFRS were adopted by the Council of Ministers of the Republic of Bulgaria in accordance with the Directives of the European Union and the national peculiarities.

In Bulgaria provisions are made that working out and presentation of annual financial statements prepared by the small and medium enterprises to be done in pursuance of the edicts and decrees of NFRS. They are applied by the enterprises, which, for at least two preceding years, do not exceed the indices of two of the following criteria:

1. balance value of the assets by December 31st – 8 million levs
2. net incomes from sales for a year – 15 million levs
3. average number of the staff for a year – 250 people.¹

The enterprises in the Republic of Bulgaria with the exception of the small and medium enterprises, mentioned as criteria above, are obliged to make out and present the annual financial statements based on IAS/IFRS. Moreover, an enterprise which, during a current period, has made out and presented its financial statement based on IAS/IFRS, cannot apply NFRS for SME. Enterprises, which are emittents according to the Law of the public supply of securities, and the crediting institutions, insurance and investment companies, societies for supplementary social insurance and the funds controlled by them, also apply IAS/IFRS. In other words, application of IAS/IFRS in Bulgaria has wide parameters.

The fact that intangibles are an increasingly important source of value for companies today reflects a shift in dominant business production and operation models to ones involving significant utilization of intangibles. Intangibles have become important largely as a result of economic factors that have intensified since the mid-1980s, particularly increased competition resulting from globalization and deregulation and an upsurge of information and communication technologies. As a result of these changes, a significant number of businesses now operate under a paradigm based on accumulation and utilization of intangibles, both alone and in conjunction with tangible assets or products. Prior to this shift, most businesses operated under a tangible asset paradigm. In addition to the increased use of intangibles in the production of goods and services, an expansion has also occurred in the consumption of goods that are themselves nonphysical, such as digital products, services, and entertainment. Furthermore, questions have arisen that are not yet resolved regarding how such resources should be treated under existing regimes and systems of measurement such as financial disclosure requirements, accounting rules and intellectual property laws.²

There are significant expenditures invested in intangibles including resources such as human capital, the long-term customer base, product and process related technologies, information technology, and brands and intellectual property. To date, the traditional categorization of expenditures evident in the financial statements does not identify and measure expenditures on these intangibles separately from expenditures on tangible investment and current production (operating expenditures). This contrasts with the accounting for tangible investment, which separately accounts for all expenditures not consumed in a single accounting period as assets. In searching for better ways to account for intangibles, to date, regulators and researchers have focused on the accounting choice problem relating to the existence and recognition of intangible assets. That is why identifying and separately reporting the expenditures on intangible investment is the logical first step in accounting for intangible investments.

A problem for financial reporting, however, is three properties of intangibles that render these investments more uncertain than tangible assets. Expenditures on intangibles are first, heterogeneous, and, second, non-standardized. Heterogeneity and standardization are a

¹ The exchange rate of Bulgarian Central Bank - 1 euro = 1.95583 lv/euro. The Republic of Bulgaria is under currency board and the exchange rate euro/lev is fixed.

² See also Bart van Ark, Understanding Productivity and Income Gaps in the OECD Area: Are ICT and Intangibles the Missing Link, (Groningen Growth and Dev. Ctr. & Conference Bd. Working Paper, 2002) (discussing the extent to which ICT and intangibles may explain gaps in labor and productivity national income statistics); see generally LEV, supra note 18 (giving a general overview of the role of intangibles largely from an accounting and policy perspective).

function of how often tasks have been performed before and the ease of copying. Plant, property and equipment are relatively standardized compared to payments for intellectual inputs from employees and payments for produced intangible assets from outside the firm. A third property of intangibles is no or weak property rights. Either the assets are embodied in employees who cannot be owned or there are rents, which are easily dissipated by imitation.

As a result of these three properties (heterogeneity, non-standardized, lack of property rights), expenditures on intangible investments are inherently uncertain. Despite this inherent uncertainty, these expenditures are undertaken with the intention of generating future benefits, and the expenditures are investments by nature. However, from an accounting perspective, full capitalisation of highly uncertain expenditures is not feasible³.

These problems provoked us to focus our research on the existing accounting rules, regarding the definition, initial recognition and measurement at fair value of the intangibles for the purposes of financial statements.

The changing nature and role of intangibles in Bulgarian business practice raises many questions for the practical accounting treatment of such resources in our enterprises.

As mentioned above, Bulgarian enterprises apply as basis for preparing the financial statements IAS/IFRS or NFRS for SME. Accounting for intangibles is regulated in NAS 38 Intangible assets and IAS 38 Intangible assets. The Bulgarian accounting standard is similar in philosophy, basic rules and requirements to the international accounting standard.

The discussion about the practice of measuring intangible assets at fair value in the financial statements of the Bulgarian enterprises is logically to be preceded by brief examination of the requirements, regarding the nature, definition, classification, acquisition, recognition and evaluation of intangibles according to IAS 38 and NAS 38.

Under the general asset definition in the conceptual framework, assets are resources expected to yield future benefits that are controlled by the entity as a result of a past transaction. Assets are recognised if: (a) it is probable the future economic benefits attributable to the asset will flow to the enterprise; and (b) the cost of the asset can be measured reliably (International Accounting Standards Board (IASB) Framework). Control means the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to the benefits (IASB Framework). Control normally stems from legal rights. However, according to paragraph 13, legal rights are not a necessary condition for control because “an entity may be able to control the future economic benefits in some other way”. IAS 38/NAS 38 Intangible Assets narrows the asset definition for intangible assets. An “intangible asset” is an identifiable non-monetary asset without physical substance.

“Identifiable” means:

(a) Separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or

(b) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

The definition of an intangible asset requires it to be identifiable in order to be separated from goodwill. In a merger or acquisition context, the difference between the amount the acquiring company pays for the acquired company and the book value of the acquired company’s assets would be recorded on the acquiring company’s balance sheet as goodwill.

In the realm of accounting treatment of intangibles, however, a further distinction exists between treatment of internally generated intangibles and purchased intangibles⁴.

³ Wyatt, A. Abernethy, M. Accounting for intangible investments.

⁴ Internally produced intangible assets include intangible assets such as patents, brands, trademarks, software produced by the firm in-house.

Purchased intangibles are capitalized and placed on a company's balance sheet. Internally generated intangible assets must be out of the "research phase" and into the "development phase" and then pass six additional tests (IAS38/NAS38)

(a) The technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) Its intention to complete the intangible asset and use or sell it;

(c) Its ability to use or sell the intangible asset;

(d) How the intangible asset will generate probable future economic benefits. Among other things, the entity must demonstrate the existence of a market for the output of the intangible asset, or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Since much of the expenditures occur before the asset becomes technically feasibility, any amounts capitalized as assets, if any, will usually be small. As a result the standards will typically require for an example, that a company capitalize purchases of computer hardware and certain types of software developed internally, but would have the company expense the other costs such as computer installation, business process development, and investments in associated intangibles.

Intangibles, which include, among other things, information technology, research and development, brand equity, intellectual property rights, corporate culture, stockholder relations, access to markets, knowledgeable workers, and management and human resources, are also referred to as knowledge assets and intellectual capital.⁵ Intangibles may include discovery/innovation aspects, such as new products and patents, human resources factors such as compensation and work practice and organizational capital aspects. According to the accounting standarts we adopt the following classification:

- Intellectual property: Intangible assets with legal or contractual rights including patents, trademarks, designs, licenses, copyrights, film rights, mastheads.

- Separately identifiable intangible assets: Information systems, networks, administrative structures and process, market and technical knowledge, human capital, brands, intangibles embodied in capital equipment, trade secrets, internally generated software, drawings, research and developement.

- Goodwill (non-separable intangible assets): Prior intangible investments embodied in organisations, management expertise, geographical position, monopoly market niche.

Intangibles can be acquired:

- by separate purchase
- as part of a business combination
- by a government grant
- by exchange of assets
- by self-creation (internal generation).

Brands, mastheads, publishing titles, customer lists, and items similar in substance that are internally generated should not be recognized as assets.

Intangible assets are measured initially at cost. Depending on the way of purchase, they are recognized as follows:

⁵ According to Arewa, O. Measuring and Representing the Knowledge Economy: Accounting for Economic Reality under the Intangibles Paradigm.

By separate acquisition: at the cost of purchase. Purchase price includes duties and non-refundable purchase taxes, but after deducting discounts and rebates.

As part of a business combination: at fair value on the acquisition day. Fair value is the

Quoted market price in an active market, which is the amount entity, would have paid in arm's length transaction. Any appropriate Fair Value technique can be used for defining the cost of an asset.

By a government grant the assets are recognized according to the rules of IAS 20/NAS 20 Accounting for government grants and disclosure of government assistance, which prescribes two approaches:

- Gross approach: Recognize intangible asset and grant at fair value.
- Net approach: The Standard permits recording both the asset and the grant at a nominal amount. This approach is not permitted in the national accounting standard.

By exchange of assets the cost is equal to the fair value of asset given up or fair value of asset received.

For internally generated intangible assets, which are a result of research and development activities IAS/ NAS 38 requires that firms:

- Charge all research cost to expense.
- Development costs are capitalized only after technical and commercial feasibility of the asset for sale or use have been established. This means that the enterprise must intend and be able to complete the intangible asset and either use it or sell it, and be able to demonstrate how the asset will generate future economic benefits.

It is obvious, that in the realm of accounting treatment of intangibles, however, a further distinction exists between treatment of internally generated intangibles and purchased intangibles.

Purchased intangibles are capitalized and placed on a company's balance sheet. Internally generated intangible assets must be out of the "research phase" and into the "development phase" and then pass six additional tests (IAS38/NAS 38):

- (a) The technical feasibility of completing the intangible asset so that it will be available for use or sale;
- (b) Its intention to complete the intangible asset and use or sell it;
- (c) Its ability to use or sell the intangible asset;
- (d) How the intangible asset will generate probable future economic benefits. Among other things, the entity must demonstrate the existence of a market for the output of the intangible asset, or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
- (e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
- (f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Since much of the expenditures occur before the asset becomes technical feasibility, any amounts capitalized as assets, if any, will usually be small. As a result the standards will typically require for an example, that a company capitalize purchases of computer hardware and certain types of software developed internally, but would have the company expense the other costs such as computer installation, business process development, and investments in associated intangibles.

The definition and basic characteristics of intangible assets in IAS 38 are similar to those in NAS 38. The minor differences that can be seen in the Bulgarian standard give it a slight nuance but, by no means, they do not change the essence of its contents. Nevertheless, various permits, licensees, accreditations and others, given by the state or its organs, meeting

the criteria of intangible assets in the Bulgarian enterprises, are not reported as such. In a similar way, intangible assets are not going to be reported if at an enterprise a scientific research work is produced which is used in production but is not patented.

Although an invention brings economic benefit to its inventor – the enterprise, and is controlled by it. In many cases, the control is the line, which allows making difference between an intangible asset and an intangible resource in the Bulgarian enterprises, such as investments in the development and education of the staff. The enterprises cannot prove enough control over the economic benefits, arising after improving the qualification of the staff, and intangible assets are not reported. This is why lists of names of customers, made by the enterprises, as well as market share, or loyalty of the customers, and the like, are not accepted to be intangible assets

The Bulgarian financial report requires clear documentary confirmation of the economic facts, events, and processes, including intangible assets. This is a result from the fact that until recently, main and almost only users of the information in the report were the different regulating organs. The compulsory requirement for properly formed documents, and the concept of document validity regulated by the law, restrict the acceptance of intangible assets in the Bulgarian practice of accountancy and push them as concepts away from the understanding for intangible assets in IAS/IFRS. Typical example is not accepting the web site for intangible assets. This asset has all features of an intangible asset:

- brings economic benefit to the enterprise,
- availability of properly formed documents, confirming the existence of the asset itself, and the right of the enterprise on the intellectual product,
- can be distinguished, will be used for a long time, i.e. the useful period is more than 12 months,
- the enterprise does not intend to sell the asset in the following 12 months,
- the real initial price can be reliably appointed,
- there is no natural-material form
- As a rule, in the enterprise there are contracts signed with physical persons or juridical persons, other enterprises, which give the service of creating a web site. The subject of the contract is to give information services and maintenance which makes its interpretation easier, especially if payment is periodical. Expenses for information services or advertising are accounted and are recognized to be common expenses and are fully entered into the composition of the expenses. Therefore, for the report, intangible assets do not come out to be object of gaining the rights of an intellectual property.

The practice of accounting intangibles at fair value in the financial reports of the Bulgarian enterprises is very closely connected with a key moment of IAS 38 and NAS 38, which is, assessment after accepting the intangibles. The problems of the value are not solved in any state. Scientific and not so much scientific disputes arise all the time, concerning the correctness of the reporting models, hence the correctness of the formulation of the report. However, the first thing to do is to define the basic model of assessment.

The model of accounting by acquisition price is a recommended, standard method of approach, in compliance with which the intangible asset, after the initial recognition is accounted at the purchase price, reduced by accumulated depreciation and accumulated losses from devaluation. The initial value of the asset is objective, i.e. it is a result from a transaction between equal partners – seller and buyer. The first one sells at a price not lower than the one which compensates his cost and guarantees some, though little profit. The second one buys at a price not higher than the one which would bring him future benefit. Thus, the purchase price (initial price) is the balance price between supply and demand, relevant to the current market value at the moment of purchasing. With this model the diversity of versions of influence on the accounting policy of the enterprise is reduced to the choice of a depreciation variant of

the intangible asset.⁶ Apart from that, intangibles are also tested for depreciation. This version is typical for the Bulgarian practice and does not need any additional explanation. Such are missing in IAS 38, as well as in NAS 38. However, in a successive period the current market price is an object of accountancy (the price that has to be paid for this moment, at present), and will change, as a rule, in the direction of increasing compared to the purchasing price. Within the years of increasing inflation, these processes can be clearly observed. The enterprises in Bulgaria which offer IAS/ISFS may prefer the model of revalued cost of intangible assets. Once chosen this model, the intangible asset, after its initial acceptance, has to be accounted at a revalued cost. It is appointed to be its fair value on the date of revaluation minus the accumulated depreciation and losses from devaluation. For the needs of the revaluation, according to IAS 38, the fair value has to be appointed at the presence of an active market. To avoid the substantial difference of the balance value of the intangible asset from its fair value, the intangible asset has to be regularly revalued.

It is important to note that the fair value does not reflect real purchasing done by the enterprise but a definitely circumstantial sum, subjectively measured, which can be calculated in case of selling the intangible asset. The fair value is assessment which is based on future payments. This distinguishes the concept of fair value from the concept of market value – the sum which can be drawn from the selling of the intangible asset on the market.

IAS/IFRS specially stipulates the circumstance, according to which the presence of the intangible asset on the market is a rare phenomenon. This is the situation on the international market, as well as in Bulgaria. In spite of all it is sometimes possible to find an active market. For example, in some jurisdictions it is possible to have an active market free negotiation of licenses for transportation of passengers, fishing, and production quota. At the same time, an active market cannot exist for trade marks, licenses for the production of music or films, patents or trade marks, as long as such assets can almost always be classified as unique. There are no two equal products, two trade marks or inventions the same, therefore, the unique asset has to have unique price. Besides, although the intangible assets are also subjects of transactions, and contracts are signed between the two parties, public transactions or auctions are rare. This is why, the price given for one intangible asset can rarely be used as a base for the fair value of another asset. Very often, the information about transaction prices is confidential and is kept a secret.

According to IAS 38, the frequency of revaluating intangible assets depends on the volatility (fluctuation) of the fair value of the depreciated intangible asset. If the fair value of the revalued asset considerably differentiates from its balance value, it is necessary to make an additional revaluation. The fair assessment of some intangible assets may be considerably altered, which requires daily revaluation of the asset.

If an intangible asset can be added to the group of the revalued intangibles, it cannot be revalued because of the fact that there is no active market for such an asset. Such an asset

⁶ In the tax laws of the Republic of Bulgaria there is a clear distinction between the terms intangible assets and tax intangible assets. According to the Corporate Taxation Law the definition for tax intangible asset coincides with the definition for the Standard of intangible assets. More interesting is the fact that the law implies tax depreciation norms and the practice of the Bulgarian accountant is restricted to obeying the law in the part for these norms and choice of depreciation variant, but any different from the legal regulations is not applied. The software and the right to use a software are separated from the other intangible assets for which there is a restricted useful period according to a signed contract or legal obligation. The annual tax depreciation norm of the software and the right to use it is 50%, and for the other intangible assets 100/ years of the legal restriction, and cannot exceed 33 1/3.

The state, presented by the tax administration, in most cases opposes the acceptance of the principle of fair price. Very often, even if it is controlled by its own rules, regulated in the norms of acknowledgement and assessment of the objects of accounting.

should be accounted at an acquisition price reduced by the accumulated depreciation and the loss from devaluation. In other words, such an asset should be accounted by the model of accounting at an acquisition price, and, if the fair price of the revalued intangible asset can no longer be determined by the active market price, its revalued cost on the date of the last revaluation, done at an active market reduced by the accumulated later depreciation and loss from devaluation.

Conclusion

Unfortunately, the peculiarity of the Bulgarian business culture, and the stock market do not benefit for the application of the fair value concept in our country in general, and in particular, for the accounting of intangible assets. The Bulgarian accountant would rather consider not fair if anything is against the law. Bulgarian accountants tend to consider that accounting is most of all doing current accounts, and the importance of the financial reports is neglected. Accountancy in Bulgaria is highly influenced by the tax law. The lack of clear and specific written accounting rules is a problem for the practice. Besides, it is not because of the fact that the concept is not legally defined but because, to make a conclusion on the fair price of the intangible asset, it is necessary to process a large amount of information.

A difficulty and main obstacle for the application of IAS/IFRS in Bulgaria is the fact that accountants are not prepared to speak out their professional opinion. The Bulgarian accountant is not inclined to reveal in the report information that requires reasoning. In conclusion, the practice of accounting intangible assets at fair price in the financial reports of the Bulgarian enterprises and the acceptance of the principle of fair presentation of accounting information is accepted with difficulty due to the following main causes:

1. Accountants are afraid to go out of the frame of their own competency;
2. The definition of fair value is considered more as a function of the valuer, rather than of the accountant;
3. The conception of fair value is rather new for the Bulgarian practice;

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