

STUDY REGARDING THE FINANCIAL REPORTING OF INTANGIBLE ASSETS. CASE OF ROMANIAN PHARMACEUTICAL INDUSTRY

Ancuța Alina Gheorghe¹
Moisescu Florentina²

Abstract

The accounting treatment of intangible assets is a particularly complex and important issue for today's economy, a knowledge based economy. For nowadays companies, these assets are inductors for success and an important factor for achieving competitive advantage. Also, these assets are an important part of the financial statements. With the increasing weight and importance of the intangible assets the need for financial information of financial statements' users has changed and the current accounting system makes it difficult to cope with these developments. Because of the uncertainty that strikes intangible assets, accounting can not capture their growing importance. Accordingly investors and other users of financial statements may not receive complete and relevant information for decision making. Basic questions arise here: Does the accounting treatment of intangible assets affect the relevance of financial information? ; May this treatment cause a misallocation of resources? The weakness is that the current accounting system can not capture all significant intangible values. Along with trying to answer the above question the purpose of this paper is to present the accounting treatment related to intangible assets according to international financial reporting standards and to analyze to what extent the accounting treatment of intangible assets affect the relevance of financial information for Romanian pharmaceutical companies listed on the Bucharest Stock Exchange

The research was qualitative type, based on empirical data recorded on a sample of 5 Romanian pharmaceutical companies, listed on the Bucharest Stock Exchange. The qualitative side is given by the fact that the study is based on interpretation, explanation, understanding.

Keywords: intangible assets, IAS 38 valuation, financial reporting

1. Introduction

The nature of investments made by companies has changed dramatically in the last quarter century. Besides the classic investments in tangible assets such as equipment, machinery, equipment and installations, investments in intangible assets become particularly important. According to the Organization for Economic Cooperation and Development, in certain countries, such as USA, Finland and the UK, the investments in intangible assets exceeded the investments in tangible assets. On the other hand, global competition, new innovative business models, the increasing importance of the services sector have increased significances of intangible assets for companies, sectors and national economies (OECD, 2011). Currently, it is increasingly recognized the importance and contribution of elements such as employee skills, knowledge, intellectual property rights, relations with suppliers and customers, software licenses to business competitiveness.

This changes in the structure of investments, according to several economists, is the expression of the transition from industrial economy to knowledge economy and knowledge-based economy, intangible assets are considered the main source of economic added value (Blaug & Lekha, 2009).

In this context, the evaluation of intangible assets or the financial reporting of intangible assets raises questions concerning the identification, evaluation and control.

Intangible assets are difficult to observe and evaluate. Terms such as "intangible assets", "intellectual capital" and "knowledge capital" are often used interchangeably. A study conducted at the request of the European Commission (Zambon, 2003), defined intangible assets as sources of non-physical expected future benefits. Lev (2001) defined

¹ Faculty of Economics and Business Administration, "Dunarea de Jos", zlataru_alina@yahoo.com,

² Faculty of Economics and Business Administration, "Dunarea de Jos", fmoisescu@ugal.ro

the intangible assets as "*rights on some future benefits that it does not have a physical form*"

2.Review of the literature

In academic literature intangibles are defined in various ways. From an economic perspective, investments in intangible assets comprise digital information (software), innovative property (research and development expenses - applied or fundamental), economic competences such as organizational capital and human capital specific (Falk, 2013). From an accounting perspective, intangible assets include software, patents, copyrights, motion picture films, licenses, franchises, patterns, design, prototypes, etc., but exclude specific human capital (Falk, 2013).

Reporting of intangible assets raises three main issues: the definition, recognition and measurement of initial costs related intangible assets, recognition and measurement of intangible assets associated future costs.

International Accounting Standards (IAS 38) defines intangible assets as identifiable non-monetary assets without physical substance. A more general definition is given by Lev (2001) according to which intangible assets are non-physical rights on future benefits. The most common examples are: software products, copyrights, patents, licenses, concessions, brands, reputation, market parties, relationships with suppliers and customers, etc. (Gîrbină & Bunea, 2009).

Definition of intangible assets has evolved in recent years, in order to provide a better understanding of the concept, to allow a proper evaluation of intangible investments and to facilitate communication between researchers, businessmen, financial analysts. It is generally considered that intangible assets have no physical substance and are linked to the legal rights they confer (trademarks, copyrights, patents, etc.) (Gîrbină & Bunea, 2009). The asemea, assets are defined as resources controlled by the enterprise as a result of past events and from which future economic benefits are expected to obtain.

By putting together all the elements, we find that the existence of intangible assets is related to fulfillment of the following four criteria: identifiable, lack of physical substance, control of the asset and future economic benefits from the use of the asset.

Not all the items listed above fulfil with the definition of intangible assets. The most important are the identifiability, the lack of physical substance, control and reliability assessment of future economic benefits.

Intangible assets can be classified according to several criteria, but usually from the perspective of accounting valuation there are three categories: expenses of research and development, goodwill and and other intangible assets such as concessions, patents, licenses, etc.

If the lack physical substance is understandable, the criterion of being identifiable is problematic. So the following question arises: How do we identify an intangible asset?.

According to IAS 38, an asset is considered identifiable if it is distinguished from goodwill. Goodwill could be recognized in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination are not individually identified and separately recognized. Goodwill in a business combination represents any excess of acquisition costs over the share in identifiable assets and liabilities of the owner, acquired at fair value exchange transaction date. Otherwise, the goodwill exceeds the amount plătităcare justăa net assets of the acquired company. Goodwill is subject to a different standard IFRS 3 "Business Combinations".

An intangible asset arising from contractual or other legal rights and this is a feature that distinguishes it from goodwill. The value of goodwill is apparent from the collection of assets that make up a merged or acquired entity created by aggregating the value of the

collection of assets through a business combination. Goodwill in a business combination as an asset recognized can not be identified individually and separately.

In other words, an intangible asset is identifiable if one of two conditions is met:

- The asset is individually identified and separated from the entity and sold, transferred through a license agreement, rented or exchanged, either individually or together with another contract with an asset or liability identifiable regardless of the entity's intention to do so either,

- The asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or other rights.

In recognition of intangible assets acquired separately judgment must be present to assess the degree of confidence attached to the future economic benefits attributable to the use of the asset on the basis of available evidence at the time of initial recognition, the greater need for external evidence.

The control of an intangible asset is exercised, if the entity has the ability to obtain future economic benefits and to restrict access to future benefits for other entities supported by legal rights in court. Otherwise control is difficult to demonstrate. Legal rights are not a *sine-qua-non* condition to control. There are other ways to control the future benefits. For example technical knowledge can generate future economic benefits. This knowledge can be protected by copyright, or a trade agreement, or legal obligation of employees to maintain confidentiality.

If an entity has skilled personnel through training and additional training that could generate future economic benefits. However it does not have enough control over future benefits for these items met in the definition of an intangible asset with no royalties.

The portfolio of customers, market shares, customer relationships and loyalty, to meet the definition of an intangible asset, the existence of legal rights to protect customer relationships, exchange transactions capable of separation gives definition and recognition criteria of an intangible asset. Recognition of an asset in the balance sheet appears it is probable that future economic benefits to flow to the entity and the asset has a cost or value that can reliably be evaluated. The entity shall exercise control over the asset's future economic benefits. Asset Control is defined as the power to obtain future economic benefits flowing from it. Future economic benefits arising from intangible assets include income from the sale of products or services, savings, cost reduction, etc.

Recognition of intangible assets reflects a compromise between relevance and reliability, conservatism and caution (Høegh-Krohn & Knivsflå, 2000). International accounting standards provide recognition criteria for each of the three categories of property mentioned above.

Recognition of an intangible asset in the balance sheet appears when it is probable that future economic benefits to flow to the entity and the asset has a cost or a value that can reliably be measured.

In the case of separate acquisition the probability criterion it is always considered fulfilled. In addition, the cost of an intangible asset can be reliably measured, consisting in the purchase price plus other direct costs attributable to the assets.

In case of acquisition as part of a business combination, the situation is more complex and subject to IFRS 3. Therefore, in accordance with IAS 38 and IFRS 3, an acquirer recognizes at the acquisition date, separately from goodwill, an intangible asset if the asset's fair value can be measured reliably, irrespective of whether the asset had been recognized by the acquiree before the business combination. A delicate problem, related to intangible assets is recognition of internally generated intangible assets (Gîrbină & Bunea, 2009). To determine if internally generated intangible assets meet the criteria for

recognition, companies classify the process of obtaining these assets in a research phase and a development phase.

Research phase only generates expenses. In this phase no intangible asset can be recognized because it can demonstrate that it will generate future benefits (Moisescu, 2010). Examples of research: obtaining new knowledge; final selection for applications that generate new knowledge; the search for alternatives for materials, devices, instruments, products, processes, systems or services; the formulation, design, evaluation and final selection of possible alternatives for materials, devices, tools, products, processes, systems or services or improved.

In the development phase, the entity may identify an intangible asset and demonstrate that it meets the definition and recognition criteria. Recognition of an intangible asset occurs if and only if the entity can demonstrate the following criteria to be met cumulatively: technical feasibility completion of the asset to be available for use or sale; The intention to complete the asset and use or sell it; Ability to use or sell the intangible asset; How the asset will generate future economic benefits by the existence of a market for active generation production or use internally estimate; Availability of technical resources, financial and other assets to complete the development and to use or sell the asset; Ability to credible assessment of costs attributable to the intangible asset during its development phase.

The development phase of a project is further advanced than the research phase. In certain circumstances the entity may identify an intangible asset and be skillful enough to demonstrate that it will generate future economic benefits possible.

To assess the entity's future economic benefits from an internally generated intangible assets use is made of the principles of IAS 36 Impairment of Assets. Specifically if the asset will generate future economic benefits only in combination with other assets, the entity applies the concept of unity generated cash IAS 36.

Examples of development activities are: design, construction and testing of models, prototypes before production and use; through new technology entity projecting tools, templates, molds and dies; design, construction and operation of a factory pilot - not of a scale economically feasible for commercial production; and design, construction and testing of a chosen alternative for materials, devices, products, processes, systems or services or enhancements.

Under development costs trademarks, technical boxes, publication titles, customer lists and items similar in substance generated internally can not be distinguished from the cost development as a whole. In conclusion these items are not recognized as intangible assets.

If the enterprise can not distinguish the two phases to create an intangible asset, it treats that expense of the project as if it were done only in the research phase.

Basically there are three possibilities of reporting changes in the value of intangible assets: depreciation, impairment and revaluation.

IAS no. 38 sets the benchmark treatment and alternate on the balance sheet valuation of intangible assets. In the cost model after initial recognition of an intangible asset shall be measured at its cost less any accumulated depreciation and less any loss depreciate. Reevaluation is an alternative treatment to estimate the value of intangible assets when the economy is affected by inflation. The entire class of intangible assets should be revalued simultaneously rejecting selective revaluation of values "resulting from the combination of costs and values" as at different dates. This model does not allow: revaluation of intangible assets that have not previously been recognized as assets; initial recognition of intangible assets at amounts other than cost. The model can be applied to an intangible asset that was received through a government grant and reputable nominal value. Reevaluation provides

that after the initial recognition of an intangible asset, to be presented at revalued amount based on fair value at the time of revaluation less accumulated depreciation and impairment losses. The fair value must be determined by reference to an active market.

3. Research hypotheses

Based on the above considerations, the questions from which I start to approach the research are "Does the accounting treatment of internally generated intangible assets affect the relevance of financial information?" and "Does the accounting treatment of internally generated intangible assets leads to a misallocation of resources?"

Most investment in intangibles are recorded as expences as soon as they are incurred (Galbreath & Galvin, 2006), according to the accounting treatment prescribed by IAS 38. On the other hand, the benefits of these investments are recorded later (Siegel & Borgia, 2007). As a result, the accounting principle of connecting expenses to income is severely biased and could unfavourably affect the value relevance of financial information (income, cash flows and the carrying amount). Given this problem, many researchers have tried to examine the association between financial information contained in the financial statements and market value using various valuation models of the company. In this context, Lev and Zarowin concluded, using a sample of US firms, that the usefulness of financial information to investors has dropped significantly in the last two decades (Baruch & Paul, 1999). The authors mention that the inability to recognize the intangible investment information as an assets, especially the intellectual capital of a company, as causing this loss in value relevance of financial information.

Other authors have also reported the existence of a decline in the financial result and value relevance of book values in explaining the market value of US companies. According to these authors, the decrease is related, in fact, to high costs associated with intangible investments. These intangible investments can not be capitalized and recorded as assets in the balance sheet, it is possible only recognize them as expenses. Thus, the impact on book value is negative (Zéghal & Maaloul, 2011).

In another study, conducted in Taiwan, Yao and Liang confirmed the results of previous studies, using a sample of Taiwanese high-tech companies. Indeed, their results show that traditional financial measures provided no significant explanatory power regarding the company's value (Liang & Yao, 2005).

However, there are papers which reject the hypothesis that intangibility reduces the value relevance of financial information. The obtained results support the idea that financial statements are less relevant for high-tech firms than for traditional companies (Zéghal & Maaloul, 2011). Likewise, other authors have shown that the relationship between market value and traditional financial variables differ in present period from the previous period, and the ability of financial variables traditional explain market value decreased for those firms that are new Economy.

Consequently we can say that the results of these studies are mixed. There is no uniform opinion on the relevance of financial information. The accounting treatment of internally generated intangible assets, coupled with an inefficient system of assessment has significant implications for companies, shareholders and society as a whole.

Intangible assets were subject to a survey by TNS Political & Social at the request of the European Commission - Directorate General for Enterprise and Industry, entitled "The investments in intangible: economic and innovation engine for growth" (2013). The study focused on the behavior of enterprises in investment in intangible assets. In this study they were examined issues such as intangible asset types that companies prefer to invest, financing - from internal resources or external sources, the reasons why companies invest in intangible assets, etc.

According to the study, company's priorities in terms of the intangible assets are customized IT solutions and services, reducing production costs, developing new products and services and increase labor productivity. In general the companies prefer to invest in internally generated intangible assets as the expense of acquired and the three activities that are most likely to be the subject of such investments are optimizing operating processes, staff training, company reputation and trademark development.

Considering that the most important share of investments in intangible assets is represented by the internally generated, companies can suffer a range of socio-economic consequences if they fail to provide adequate and relevant information for shareholders and potential investors. These consequences, such as information asymmetry, high cost of capital, high risk, lack of liquidity, can lead to misallocation of resources in the capital market. Moreover, financial accounting scientific literature acknowledged the existence of market imperfections due to information asymmetry. In this context, inaccurate reporting of intangible assets in the financial statements, in addition to their specificity for the company, creates high levels of asymmetric information between internal and external investors. Insider's investors generally hold the advantage of a plus of information regarding the company and intangible assets. This advantage allows them to make favorable adjustments in their portfolio at the expense of outside investors. Due to their disadvantage, foreign investors will demand, in general, a higher rate of return on invested capital. As a result of the inadequate accounting treatment of internally generated assets and the negative consequences that could result from this, international accounting bodies have made considerable efforts to improve the quality of accounting information. They designed models and guides for additional information to be reported in the notes to the financial statements. They have particular regard to non-financial reporting information related to intangible assets. A sensitive element from investment is the intangible costs of research and development (Michael & Mihalcic, 2011). Most Romanian companies believe that research and development is a key element of economic competitiveness, but, however, in the whole country, investments in R & D represent only 0.4% of GDP, the lowest rate in the 10 countries Central who participated in the study of CE Deloitte Corporate R & D Report 2014. According to the same study 71% of local companies said they plan to increase spending on research and development in the coming years. On the other hand according to data presented by the National Institute of Statistics, the GDP share allocation for R&D activity in 2014 was located at the lowest level since 2005, 0.38% of GDP. This value puts Romania in the last position of EU Member States and is far away from the 2% already achieved the European average. There is a major change to the business environment, where the interest for R&D is relatively small, but highly concentrated in a few areas such as automotive and IT sector.

Table no. 1 - Structure of expences for R&D component

Anul	2006	2007	2008	2009	2010	2011	2012	2013	2014
Share of GDP (%)	0,46	0,54	0,59	0,48	0,47	0,48	0,49	0,39	0,38
allocated amounts (mld lei)	1,57	2,18	2,51	2,36	2,41	2,79	2,36	2,46	2,55
Of which (%)									
Personnal	51,9	53,3	48,8	57,8	57,1	53,9	55,5	56,4	54,9
Material costs	24,8	21,2	26,1	19,3	15,6	15	12,5	11,7	12,6
Other costs	23,3	25,5	25,1	22,9	27,3	31,1	32	31	32,5

Source – <http://www.insse.ro/cms/ro/content/> activity of research and development

While the average amounts invested in research and development reach an average of 2% of GDP in the European Union (maximum 4% for Sweden and Finland), in Romania these are at around 0,3 - 0,4% a level equal to that of Poland and Slovakia and half of that of Hungary and the Czech Republic. The number of researchers in Romania was reduced

dramatically since 1990 and currently stands at barely a third of the EU average. The private sector performs modest in terms of innovations. The European Union still more than half of research and development contribution is given by private companies, while in Romania it is only 23%, mostly constituted by public funds.

Table no. 2 – Total expenditure in research and development, the finance and sector performance in 2014 (millions lei)

Source of funding \ Sector of performance	Total	Business sector	Government sector	Higher education sector	Private non benefit sector
TOTAL	2555,7	1059,4	1097,8	389,0	9,5
Companies	841,2	627,5	186,7	26,9	0,1
Public funds	1240,8	201,4	818,7	214,4	6,3
Privat - non-profit	2,4	0,2	0,6	1,0	0,6
Higher education	36,9	1,9	1,2	33,8	
Foreign	434,4	228,4	90,6	112,9	2,5

source – http://www.insse.ro/cms/ro/content/activity_of_research_and_development

After funding sources of total R & D expenses in 2014, public funds had the highest share (48.6%), followed by private funds – from the companies (32.9%).

4. Study on financial reporting of intangible assets by pharmaceutical companies listed on BSE

The pharmaceutical industry is a sector where R&D costs, intellectual property rights, regulation, procedure for authorizing medicinal products, etc. are very important elements. If the firm performs a new drug patent and its implications are significant for company value. In our approach, our objective was to analyse if the pharmaceutical sector companies listed on BSE comply with the minimum criteria on the inclusion of information in the notes of significant items related to intangible assets required by accounting regulations harmonized with IAS / IFRS. In order to grasp the practical issues on reporting intangible assets we analyzed the published financial statements, the notes and the auditors reports for Romanian listed pharmaceutical companies. The source of data is the information being published www.bvb.ro and individual sites companies. In Romania there are 170 companies active in the production of drugs. Of these only five are listed companies. The 5 companies which are the subject of the case study are: Zentiva, Antibiotice, Biofarm, Meduman and Sintofarm. These companies have as main activity is the manufacture of basic pharmaceutical products (CAEN 2110) and manufacture of pharmaceutical preparations.

Table no. 3 – Intangible assets reporting in annual financial statements (thousand euro)

Company	2014	2013	2012	2011	2010
Zentiva SA	135	81	94	167	111
Antibiotice SA	1.769	1.364	1.103	382	464
Biofarm SA	45	56	44	201	272
Meduman SA	242	243	245	281	338
Sintofarm SA	5	17	31	5	3

The highest values of the intangible assets they report company Antibiotice SA and lowest values are reported Sintofarm (table no. 3). The highest proportion of intangible assets to total assets are recorded Meduman SA (table no. 4).

Table no. 4 – The share of intangible assets in total assets reported (%)

Company	2014	2013	2012	2011	2010
Zentiva SA	0,16%	0,10%	0,13%	0,21%	0,12%
Antibiotice SA	1,57%	1,20%	0,95%	0,37%	0,51%
Biofarm SA	0,10%	0,12%	0,10%	0,47%	0,69%
Meduman SA	8,83%	10,66%	10,87%	11,73%	15,45%
Sintofarm SA	0,17%	0,60%	1,20%	0,21%	0,13%

In order to achieve the stated objectives, my goal was to find in the annual financial reports answers to following questions:

1. Does the company shows the movement of intangibles, both increases and decreases during the period, offering details for exynamics of intangible assets?
2. Does the entity discloses adjustments related to intangible assets impairment accompanied by a brief explanation of causes related?
3. Does the entity mentions the amortization method of intangible assets for each category?
4. Does the company disclose any details regarding the R & D?
5. Does the company gives details of intangible assets in progress?
6. Are the information on intangible assets are presented in the annual report, prepared in accordance with the regulation no. 1/2006 NSC?

Following the qualitative analysis carried out, we found that the information gathered shall be briefly presented, that does not follow the line drawn by IAS 38 and does not lead to comprehensive information to investors. For example, they are given information regarding the movements of intangible assets, gains and reduction, but without providing details on the dynamics and structure. I found no information regarding the adjustments for depreciation or amortization methods. There are offered minimal information on research and development. The companies included in Note 1 "assets" on the numerical data increases, disposals and transfers of intangible assets during the year, but the figures are rarely accompanied by explanations concerning transactions. Values shown are not explained or interpreted. Some companies mentioned in note "principles, policies and accounting methods" intangible items, specifying the method and amortization period. Similarly, for intangible assets in progress are offered values, but are not offered details on these items. Information on intangible assets in the annual report, prepared in accordance with provisions of the Regulation contains basic information and do not contain any information referitoare la intangibles. The research was qualitative in nature, based on empiric data recorded on a sample of five Romanian companies listed on the Bucharest Stock Exchange. Qualitative research side is the fact that the study is based on interpretation, explanation, understanding. In literature and quantitative models were developed to study intangible assets. These models resort to quantitative measurement, quantification, digital data of phenomena which will be studied.

Conclusion

Intangible assets are characterized by delicate issues on the assessment and recognition in the financial statements. As a result it was impossible to develop an overarching accounting standard. IAS 38 is an attempt to impose a uniform set of rules regarding intangible assets. IAS 38 imposes strict limits regarding certain assets, particularly internally generated. However the argument that it can not establish a relationship between the cost of the asset and future income streams is applicable to tangible assets. Exclusion rule is internally generated intangible assets and supersede the tests for recognition of these assets.

The issue of financial and non-financial reporting of intangible assets attracted the interest of many researchers worldwide. Unfortunately there is very little literature concerns about the financial and non-financial reporting of intangible assets by Romanian firms.

Future research directions will consider extending the analysis to a sample Romanian companies and identify factors that influence the amount of information published by the companies on the Romanian intangible assets.

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