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Professional 1: Corporate Reporting
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Intangible Assets

Introduction
In recent years the recognition and measurement of intangible assets has been one of the most controversial areas of financial reporting. Many businesses now operate and compete with significant intangible assets such as brands, knowledge capital and people. Chief executives of these businesses clearly accept that some intangibles, particularly internally generated ones, are difficult to value. However, there has been criticism that accounting practice in this area is out of date, unhelpful to users and in need of reform. It would appear that with regard to intangibles, reliability has superseded relevance.

Intangible assets are identifiable non-monetary assets without a physical presence which have been created through time and expense, and can be identified as separate assets which will provide future economic benefits to the business. IAS 38, *Intangible Assets*, defines an intangible asset as "*an identifiable, non-monetary asset without physical substance*"

Examples of assets that might be classified as intangible include patents, trademarks, import duties, fishing licences and computer software. Students often get confused as to how an intangible asset can be classified as non-monetary when we actually value them in the financial statements. The definition is highlighting that items such as cash, bank deposits and trade receivables are monetary assets and are therefore to be excluded. Goodwill and brand image are also examples of intangible assets which need to be identified separately before they can be included as assets of the business. Where goodwill and brands have been acquired externally, their cost and existence can be identified and capitalised. Internally generated goodwill cannot be recognised as an asset as it is not separable from the business nor has it arisen from contractual or other legal rights. Its cost cannot be measured reliably.

IAS38 reflects the key principles outlined in the IASB *Framework,* for example, the definition of an asset is: *a resource* ***controlled*** *by the entity as a result of past events from which* ***future economic benefits*** *will flow to the entity*.

Identifiably and Control

An intangible asset must be 'identifiable'. This is included in IAS38 in order to distinguish intangible assets from goodwill arising on business combinations. An asset is identifiable when it is **separable** (capable of being separated from the entity and sold) and it arises from **contractual or other legal rights**. Motion picture films, fishing licences and import quotas arise from contractual or legal rights. The second condition is designed to cover assets that are not separable, but are nevertheless valuable. An intangible asset must be under the control of the entity so the entity has the power to obtain the future economic benefits from the asset. This control will usually (but not necessarily) stem from legally enforceable rights. In the absence of such rights, it is more difficult to prove that an asset exists. For example:

- Control over technical knowledge or know-how only exists if it is protected by legal right such as copyright or a patent.
- Expenditure on staff training courses may be expected to increase skills of the staff and generate future economic benefits. However, the entity incurring this expenditure may have little control over the staff, who could decide to move to a different employer. A similar issue arises in evidencing that an entity has sufficient control over market share and customer loyalty to meet the definition of an intangible asset.

Recognition and Measurement

An item is recognised as an intangible asset if it meets the definition of an intangible asset outlined above and also satisfies the usual recognition criteria for an asset outlined in the IASB *Framework*. In line with the *Framework,* IAS38 states an intangible asset should only be recognised if, and only if, BOTH the following occur:

1. It is probable that the future economic benefits that are attributable to the asset will flow to the entity, and
2. The cost can be measured reliably.

Clearly management will have to exercise an element of judgement in assessing the degree of certainty attached to any expected economic benefits. IAS38 states that intangible assets should be measured initially at their cost. If an asset is acquired in a normal transaction, then the fact that a price has been paid for the asset, is a reflection of the expectation that future economic benefits will flow to the entity. In addition, the asset cost can usually be measured reliably. Mastheads, licences, copyrights, patents are all examples of assets that can be acquired externally and meet the recognition criteria. The cost of such assets comprises the purchase price (including duties and non-refundable taxes), and any directly attributable costs of preparing the asset for its intended use. An example of the latter cost would be legal and professional fees.

Example 1

Aston Ltd acquires new energy efficient technology that will significantly reduce its energy costs for manufacturing. Costs incurred include:

Cost of new solar technology	1,500,000
Trade discount provided	200,000
Training course for staff in new technology	70,000
Initial testing of new technology	20,000
Losses incurred while other parts of plant shut down during testing and training.	30,000

The cost that can be recognised and capitalised is:

Cost	1,500,000
Less discount	(200,000)
Plus initial testing	20,000
	1,320,000

An intangible asset may be acquired in a business combination. If an intangible asset is acquired in a business combination, the cost of the asset is specified by IAS38 (in accordance with IFRS3) to be its fair value on the date of acquisition. The fact that a price can be established for an intangible asset which is acquired in a business combination is accepted as evidence that future economic benefits are expected to accrue to the entity.

Internally generated intangibles

Internally generated goodwill can never be recognised as an asset (as per IAS38). The main problems in deciding whether internally generated assets are to be recognised are in terms of determining when an intangible comes into existence and measuring its cost reliably. IAS38 has therefore introduced additional requirements such that the internal generation of an asset should be classified into a 'research phase' and a 'development phase'. Note that these phrases relate to all intangibles, not just what would normally be regarded as research and development expenditure.

Any expenditure that arises in the research phase should be recognised as an expense when incurred. The rationale being, there is insufficient certainty as to whether future economic benefits will occur. Examples of this type of activity are specifically outlined in the standard and include: Activities aimed at obtaining new knowledge; search for, evaluation and final selection of applications of research findings or other knowledge; search for alternatives for materials devices, products, processes or services.

IAS 38 states that development costs qualify for recognition as intangible assets provided the following strict criteria apply. These include:

- Technical feasibility of completing the intangible asset so it can be used or sold
- Intention of entity to complete the asset and use or sell it
- How the intangible asset will generate future economic benefits
- Availability of adequate technical, financial and other resources to complete the development and to use or sell asset
- Its ability to measure reliably the expenditure attributable to the asset.

Example 2

Baxter plc is preparing its accounts for the year ended 31 May 2009 and is unsure how to treat the following items.

1. The firm completed a big marketing and advertising campaign costing £2.4m. The finance director had authorised this campaign on the basis that it would create £5m of additional profits over the next three years.

2. A new product was developed during the year. The expenditure totalled £1.5m of which £1m was incurred prior to 30 November 2008, the date on which it became clear that the product was technically viable. The new product will be launched in the next four months and its recoverable amount is estimated at £700,000.
3. Staff participated in a training programme which cost the company £300,000. The training organisation had made a presentation to the directors of Baxter outlining that incremental profits to the business over the next twelve months would be £500,000.

What amounts should appear as assets in Baxter's statement of financial position as at 31 May 2009?

Solution

The treatment in Baxter plc's statement of financial position at 31 May 2009 will be as follows:

Marketing and advertising campaign: no asset will be recognised, because it is not possible to identify future economic benefits that are attributable only to this campaign. All of the expenditure should be expensed in the statement of comprehensive income.

New product: development expenditure appearing in the statement of financial position will be valued at £500,000. The expenditure prior to the date on which the product becomes technically feasible is recognised in the statement of comprehensive income.

Training programme: no asset will be recognised, because staff are not under the control of Baxter plc and when staff leave the benefits of the training, whatever they may be, also leave.

Valuation of intangibles after recognition.

IAS 38 states that intangible assets can be measured initially at cost, under the cost model, and subsequently carried at cost less accumulated amortisation and impairment losses.
The intangible asset can alternatively be included, under the revaluation model, at its fair value less accumulated amortisation and impairment losses. In terms of accounting for revaluation gains and losses the rules are identical to the corresponding rules in IAS16 with regards to revaluation of property, plant and equipment.

Example 3

1. Company A acquired an intangible asset on 30 June 2007 for £60,000. The asset was revalued at £80,000 on 30 June 2008 and £45,000 on 30 June 2009.

2. Company B acquired an intangible asset on 30 June 2007 for £90,000. The asset was revalued at £75,000 on 30 June 2008 and at £95,000 on 30 June 2009.

Assuming that the year-end for both companies is 30 June, and that they both use the revaluation model, show how each of these transactions should be dealt with in the financial statements.

Solution

Company A: the £20,000 revaluation increase on 30 June 2008 should be credited to the revaluation reserve and recognised as other comprehensive income. £20,000 of the revaluation decrease on June 2009 should be debited to revaluation reserve and recognised as a (negative figure) in other comprehensive income. The remaining £15,000 should be recognised as an expense.

Company B: the £15,000 revaluation decrease on 30 June 2008 should be recognised as an expense. £15,000 of the £20,000 increase on 30 June 2009 should be recognised as income. The remaining £5,000 should be credited to revaluation reserve and recognised as other comprehensive income.

Life of an intangible asset

The useful life of intangible assets needs to be assessed as finite or indefinite. An intangible asset with a finite life needs to be amortised on a systematic basis over its life. The useful life of an intangible asset that has arisen from a contract such as a licence or a patent cannot
exceed the period of the contract or legal agreement. The method of amortisation, straight line or diminishing balance should reflect the asset usage, be applied consistently and the appropriateness of the remaining life and method should be reviewed on an annual basis. Amortisation should start when the asset is available for use and cease at the earlier of the date the asset is classified as held for sale (IFRS5) and the date the asset is derecognised. If the asset is revalued above cost the increase in amortisation can be transferred from the revaluation reserve to the retained earnings, therefore not impacting on the statement of comprehensive income. Any changes in the expected residual value need to be treated as a change in an accounting estimate as per IAS8. An asset with no foreseeable limit to the period of benefit to the entity can be classified as having an infinite life and will not be amortised. The classification needs to be reviewed for every accounting period.

Disclosure

The main disclosures required by IAS38 are as follows:

For each class of intangible assets, disclosure is required of the following, distinguishing between internally-generated intangibles and other intangibles.

- The method of amortisation used
- Useful life of the assets or the amortisation rates used
- The gross carrying amount, any accumulated amortisation at the beginning and end of the period
- The line item(s) of the statement of standard comprehensive income in which any amortisation of intangible assets is included
- A reconciliation of the carrying amount at the beginning and the end of the period.

The financial statements should also disclose:

- In the case of intangible assets that are assessed as having an indefinite useful life, the carrying amounts and the reasons supporting the assessment of indefinite useful life.
- The carrying amount, nature and amortisation period of any individual intangible asset that is material to the financial statements of the entity as a whole.

The accounting policy note from Tesco’s 2009 financial statements is as follows:

Intangible assets

Acquired intangible assets, such as software, pharmacy licences, customer relationships, contracts and brands, are measured initially at cost and are amortised on a straight-line basis over their estimated useful lives, at 2%-100% of cost per annum.

Internally-generated intangible assets – Research and development expenditure. Research costs are expensed as incurred. Development expenditure incurred on an individual project is carried forward only if all the criteria set out in IAS 38 'Intangible Assets' are met, namely: an asset is created that can be identified (such as software or new processes); it is probable that the asset created will generate future economic benefits; and the development cost of the asset can be measured reliably. Following the initial recognition of development expenditure, the cost is amortised over the project's estimated useful life, usually at 14%-25% of cost per annum.

Example 4

As the financial controller of Star plc, a company operating the pharmaceutical sector, you have been provided with the following information by the director of research:

Drug Beta

Commercial production started on 1 June 2005 for Beta. At 30 November 2008, £50,000 has been capitalised in respect of development expenditure on this drug. During the year a further £10,000 was spent on development of Beta. Star plc have taken out a patent in respect of Beta which will last 8 years. Legal and professional fees in relation to this amounted to £1,600. Current sales of Beta for the year ended 30 November 2009, amounted to £50,000. Sales over the next three years are expected to be £150,000, £220,000 and £100,000 respectively.

Drug Alpha

The development of this revolutionary drug for the treatment of dementia is at a much earlier stage. The research director of Star plc believes there is real commercial potential and fully expects major profits to arise from this drug. Not all the directors are convinced of the commercial viability of Alpha. Expenditure on this project during the year ended 30 November 2009 amounted to £31,000.

Required

i. Calculate the total amount to be charged to the statement of comprehensive income in respect of each of the above in the year ended 30 November 2009.

ii. Show the movement on intangible assets which would appear in the notes to the financial statements of Star plc for the year ended 30 November 2009.

Solution

Total amount to be charged to the statement of comprehensive income for the year ended 30 November 2009:

Alpha (not yet qualifying as development phase)	31,000
Amortisation of development costs (Beta) - Working 1	5,769
Amortisation of patent (£1,600/8)	200
	36,969

Notes to the financial statements as at 30 November 2009 (extracts)

Intangible assets

	Development Costs	Patents	Total
	£	£	£
Cost			
At 1 December 2008	50,000	-	50,000
Additions	10,000	1,600	11,600
At 30 November 2009	60,000	1,600	61,600
Amortisation			
At 1 December 2008	-	-	-
Charge for year	5,769	200	5,969
At 30 November 2009	5,769	200	5,969
Carrying amount			
At 1 December 2008	50,000	-	50,000
At 30 November 2009	54,231	1,400	55,631

Working 1

Sales in year/ total sales x £60,000

$$\frac{£50,000}{£50,000 + £150,000 + £220,000 + £100,000} \times £60,000 = £5,769$$