Accounting for Intangible Assets

By: Brendan Doyle, BA (Hons) in Accounting, MBS Accounting, MA, H. Dip. Ed.
Acting Head of Department of Accounting & Business Computing in Athlone Institute of Technology, Examiner CPA: Professional 1 Corporate Reporting

This article is designed to assist students in preparing for questions on the topic of Intangible Assets on the P1 Corporate Reporting paper. It is also likely to be of benefit to students of P2 Advanced Corporate Reporting and F2 Financial Accounting.

Introduction:
Intangible assets have become increasingly significant in recent years. Particular developments in the business world have led to growing value provided by knowledge, know-how and processes at the relative expense of tangible assets such as property and machinery. Many of the world's most valuable businesses depend to a massive degree on the value of their intangibles. Think of Facebook, worth some $300 billion justified primarily by the perceived value of its gigantic user base. This is also the case with Airbnb, Uber, and other global corporate giants. It becomes very important that intangible assets are recognised, measured and presented in such a way that useful information can be generated for the users of these companies' financial statements.

Of course, it is not just new economy companies that have significant intangible assets. Pharmaceutical companies have traditionally derived their profits from exploitation of patents. Many manufacturing companies, such as motor companies, generate substantial patents in the course of their research and development, many of which possess significant value.

Accounting Standard:
The relevant accounting standard for intangible assets is IAS 38 *Intangible Assets*. This standard was originally issued in September 1998 as a replacement for IAS 9, which was originally issued in 1978. The most recent version is that revised in January 2008. Its primary objective is to describe the accounting treatment for intangible assets, unless they are dealt with by another standard.

Definitions:

An intangible asset is an identifiable non-monetary asset without physical substance.

An asset is defined under the Conceptual Framework as a resource controlled by an entity as a result of past transactions and events, and from which future economic benefits are expected to flow to the entity.

An asset of any kind is identifiable if it either:

- Is separable, meaning that it can be separated from the business and sold individually, or
- Arises from contractual or other legal rights, even if these are not separable or transferable.

Hence, goodwill is not an identifiable asset, and is excluded from the definition of an intangible asset under IAS 38.

A monetary asset is an asset representing a fixed amount of money receivable. These assets are covered under IFRS 9 *Financial Instruments*, hence they are excluded from IAS 38.

The entity must have the ability to control the asset in order to obtain economic benefit from it. Control exists if the entity has the power to obtain the future economic benefits flowing from the resource.

Examples of intangible assets include: brand names, software, licences, franchises, copyrights, patents, customer lists, quotas, etc…

Recognition, Measurement and Presentation:
An intangible asset should be recognised if:

- It is probable that the economic benefits associated with the asset will flow to the entity, and
- The cost of the asset can be measured reliably.

If these criteria are not met, any relevant expenditure should be expensed.

IAS 38 provides detailed guidance in respect of the application of the recognition criteria to specific cases of intangible asset acquisition.

- Assets purchased separately:
    - If the asset was purchased separately, recognise it as an intangible at cost provided it meets the definition above.
    - Cost is deemed to include any directly attributable cost of preparing the asset for its intended use.
    - If the asset is acquired for free or nominal sum by way of government grant e.g. radio licence, it may be recognised at fair value (under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*). If this option is not taken, it must be recognised at cost including directly attributable expenditure.

- Purchased as part of a group of assets (e.g. takeover of a business including one or more intangible assets):
    - If purchased as part of a business, capitalise the intangible at fair value if this can be reliably measured on initial recognition. If not, ignore the asset and include its value within goodwill.
    - The cost of assets acquired under an exchange is measured as the fair value of the asset given up in return.

- Internally generated intangibles:
  - Internally generated goodwill should never be recognised.
  - Internally generated brands, titles, customer lists and similar items are not recognised as intangible assets. This is because under IAS 38 they are deemed indistinguishable from the costs of developing the business as a whole.
  - Any costs involved in research or from the research phase of an internal project must be expensed.
  - Costs incurred in developing an intangible asset should be capitalised only if all the following criteria are met:
    - Probable that product being developed will generate future economic benefits;
    - Intention to complete and use / sell;
    - Resources are available to complete project;
    - Ability to use / sell;
    - Technical feasibility of the product being developed;
    - Expenditure can be measured reliably.
  - Computer software should generally be capitalised at cost, but operating systems should be included with the hardware cost within Property, plant & equipment, not within intangibles. This is because equipment is generally inoperable without the operating system.
  - Any expenditure initially written off as an expense may not be subsequently capitalised under any circumstances. However, an intangible asset written off due to changes in circumstances may be reinstated if those circumstances reverse.

Subsequent Expenditure

- Any amounts spent on intangible assets subsequent to their acquisition should be expensed as incurred unless the expenditure will enhance the economic benefits arising from the asset beyond those originally assessed (similar to rule for tangible non-current assets).

Amortisation of intangible assets

- If intangibles are considered to have an indefinite useful economic life (UEL), they should not be amortised. If this is the case, an annual impairment review is required.
- If UEL is not indefinite, amortise the asset over the UEL using a method which best reflects the pattern of consumption of economic benefits. This period should be reviewed at least annually.
- The amortisation charged should be expensed to profit or loss unless it is required to be capitalised by another standard.

Revaluation of intangibles

- Intangibles may be revalued only if an active market exists in identical assets with publicly available prices. Most intangibles will not qualify for revaluation as they are unique. Unique assets cannot have active markets in identical assets.
- If one intangible asset is revalued, all intangibles of a similar class must also be revalued as far as possible.
- The entity may choose to adopt the cost model under IAS 38, therefore never revaluing assets.
- Treatment of revaluation gains and losses is similar to that of tangible non-current assets.

Conclusion
It is clear that significant judgment needs to be exercised by preparers to ensure that IAS 38 is applied fairly. Some judgments are precluded by IAS 38, e.g. the requirement that we cannot capitalise internally generated brands or customer lists. The reason for this requirement is that such judgments are open to abuse and manipulation. However there remains significant scope for judgment in areas such as whether the conditions for capitalising development costs are met. This can lead to earnings management if such judgment is abused.

There are also many arguments that the exclusions are too strict. For example, the preclusion from recognising internally generated customer lists prevents Facebook from recognising its valuable customer base as an intangible asset (under IFRS). This is clearly its most valuable asset, yet it is prevented from recognising its value in its financial statements. Many argue that deficiency threatens the relevance of financial statements in the case of companies such as Facebook.

Hence, it is likely that we will see further revisions of this standard in the future.