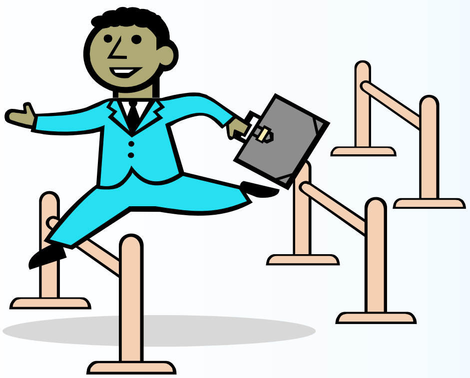
Intangible Assets – IAS 38



Road Map on IAS 38

1. Definition of intangible asset
2. Recognition and measurement
3. Recognition of expense
4. Measurement after recognition
5. Useful life
6. Intangible assets with finite useful lives
7. Intangible assets with indefinite useful lives
8. Impairment
9. Retirements and disposals

Definition of Intangible Assets

An intangible asset is

- an identifiable non-monetary asset without physical substance.

Identifiability

An asset is a resource:

a) controlled by an entity as a result of past events; and

b) from which future economic benefits are expected to flow to the entity.

Control

Future economic benefit

Monetary assets are

- money held and assets to be received in fixed or determined amounts of money

Definition of Intangible Assets

More clarification on its meaning

Identifiability

- An asset meets the Identifiability Criterion in the definition of an intangible asset when it:

a) is separable

b) arises from contractual or other legal rights

Definition of Intangible Assets

An entity controls an asset if the entity has the power

- to obtain the future economic benefits
- restricts the access
- legal rights.

Control

•In the absence of legal rights to protect, an entity usually has insufficient control over the expected future economic benefits

– for example, a team of skilled staff, or customer relationships and loyalty

Definition of Intangible Assets

Future economic benefits may include

revenue from the sale of products or services

–– cost savings, or

– other benefits resulting from the use of the asset by the entity.

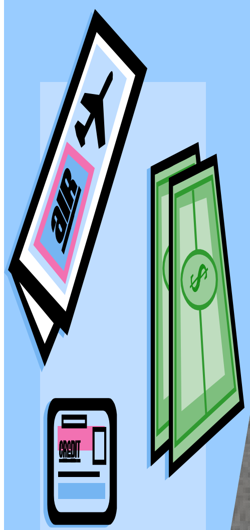
• For example, the use of intellectual property in a production process

– may reduce future production costs

– rather than increase future revenues.

Future economic benefit

Recognition and Initial Measurement



Recognition criteria

a) it is probable that the expected future economic benefits will flow to the entity; and

b) the cost of the asset can be measured reliably.

- An entity shall assess the probability using reasonable and supportable assumptions

Initial measurement at cost

Rarely subsequent expenditure as a result of addition or replacement is added to an Intangible Asset

Recognition and Initial Measurement

Intangible assets may arise from

1. Separate acquisition
2. Acquisition as part of a business combination
3. Acquisition by way of a government grant
4. Exchange of assets
5. Internally generated goodwill
6. Internally generated intangible assets

Recognition and Initial Measurement

Separate acquisition

- The price an entity pays to acquire separately an intangible asset

– reflects the probability that the expected future economic benefits will flow to the entity.

- The cost can usually be measured reliably

Cost comprises?

– in particular when the purchase consideration is in the form of cash or other monetary assets.

Recognition and Initial Measurement

Separate acquisition

The cost comprises:

a) its purchase price,

b) any directly attributable cost of preparing the asset

for its intended use.

Recognition and Initial Measurement

Which cost can or cannot be included?

Separate acquisition

- Directly attributable costs are:

a) costs of employee benefits

b) professional fees

c) costs of testing

- Expenditures that are not part of the cost of an intangible asset are:

a) costs of introducing a new product or service (including costs of advertising and promotional activities);

b) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

c) administration and other general overhead costs.

Recognition and Initial Measurement

Separate acquisition

When should recognition of cost be ceased?

Ceases when the asset is

- in the condition necessary for it to be capable of operating in the manner intended by management.

— For example, the following costs are not included in the carrying amount of an intangible asset:

a) costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use; and

b) initial operating losses, such as those incurred while demand for the asset's output builds up.

Recognition and Initial Measurement

Separate acquisition

If payment for an intangible asset is deferred beyond normal credit terms

- its cost is the cash price equivalent.

- The difference between

– this cash price equivalent and

– the total payments

is recognised as interest expense over the period of credit unless it is capitalised in accordance with the capitalisation treatment permitted in IAS 23 *Borrowing Costs*.

Recognition and Initial Measurement

Acquisition as part of a business combination

IFRS 3 *Business Combinations*, an intangible asset is acquired in a business combination:

cost of intangible asset = its fair value at acquisition date.

– Fair value of an intangible asset = market expectations that future economic benefits will flow to the entity.

Probability recognition criterion is always considered to be satisfied for intangible assets acquired in business combinations.

Recognition and Initial Measurement

Acquisition as part of a business combination

In accordance with IAS 38 and IFRS 3

– an acquirer recognises at the acquisition date separately from goodwill an intangible asset of the acquiree

- if fair value can be measured reliably,
- irrespective of whether the asset had been recognised by the acquiree before the business combination.

Some items, like in-process R&D project,

– that were ineligible for recognition in the acquiree's books if it is generated internally,

– may be recognised by the acquirer (separately from goodwill) in the business combination if the item

- meets the **definition** of an intangible asset, and
- The asset's **fair value** can be measured reliably.
- Is identifiable

Recognition and Initial Measurement

Acquisition as part of a business combination

Separate acquisition

Both may result in the recognition of an in-process R&D project

- But how should the subsequent expenditure on such acquired in process R&D project be recognised?

- Such expenditure shall be accounted for:
- in the same practice as other research or development expenditure

(or internally generated intangible assets),

i.e. the practice to be discussed later in

Internally generated intangible assets

Recognition and Initial Measurement

Acquisition by way of a government grant

- An intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant.
- In accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, an entity may choose to
  - recognise both the intangible asset and the grant initially at fair value (in accordance with IAS 20), or
  - recognises the asset initially at a nominal amount (the other treatment permitted by IAS 20) plus any expenditure that is directly attributable to preparing the asset for its intended use.

Recognition and Initial Measurement

Exchange of assets

Commercial Substance

Fair Value of Exchanged Assets

Measured at fair value exceptions:

a) lacks commercial substance or

b) the fair value of neither the asset received nor the asset given up is reliably measured

- Similar to the requirements in IAS 16 *Property, Plant and Equipment*

- If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

Recognition and Initial Measurement

Internally generated goodwill

- Internally generated goodwill shall not be recognised as an asset.

– Because it is not an identifiable resource (neither separable nor arising from contractual or legal rights) controlled by the entity that can be measured reliably at cost.

Recognition and Initial Measurement

Internally generated intangible asset

Research and Development

- To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

a) research phase; and

b) a development phase.

- ‘research phase’ and ‘development phase’ have a broader meaning for the purpose of IAS 38.

If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset

- treats the expenditure on that project as if it were incurred in the research phase only.

Recognition and Initial Measurement

Research and Development

- **<u>Research</u>** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

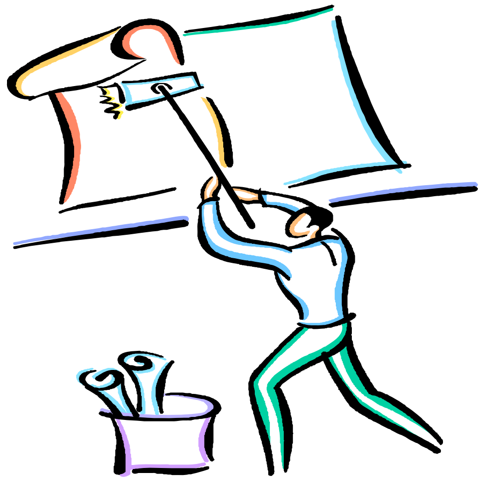
<u>No</u> intangible asset arising from research (or from the research phase of an internal project) **<u>shall be recognised</u>.**

- Expenditure on research (or on the research phase of an internal project) shall be recognised **<u>as an expense</u>** when it is incurred.

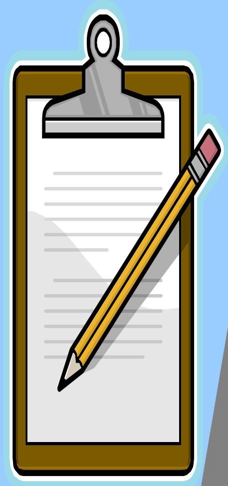
Recognition and Initial Measurement

Research and Development

- **Development** is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.



Recognition and Initial Measurement



Research and Development

An intangible asset arising from development shall be recognised if:

a) Completion of the technical feasibility.

b) Intention to complete and use or sell it.

c) Ability to use or sell

d) Will generate probable future economic benefits.

e) the availability of adequate technical, financial and other resources to complete

f) Ability to measure reliably the expenditure attributable

Recognition and Initial Measurement

Research and Development

• To demonstrate how an intangible asset will generate probable future economic benefits,

– an entity assesses the future economic benefits to be received from the asset using the principles in IAS 36 *Impairment of Assets*.

• If the asset will generate economic benefits only in combination with other assets,

– the entity applies the concept of cash-generating units in IAS 36.

How can probable future economic benefits be demonstrated?

Recognition and Initial Measurement

Research and Development

- Even if the recognition criteria are met,

– internally generated brands, mastheads, publishing titles, customer lists and items similar in substance

  - shall not be recognised as intangible assets.

- Specifically disallowed in IAS 38

Recognition and Initial Measurement

Research and Development

- The cost of an internally generated intangible asset
  - is the sum of expenditure incurred <u>from the date when</u> the intangible asset first meets the recognition criteria.
  - <u>prohibits reinstatement of expenditure</u> previously recognised as an expense.

Recognition and Initial Measurement

Research and Development

When can the cost be capitalised?

Research

Development

Expensed and cannot be restated

Capitalised as intangible asset

Date 1 – Date of development commenced
Date 2 – Date of recognition criteria meet
Date 3 – Date of new developed product ready for intended use

Recognition and Initial Measurement

Research and Development

- The following are not cost of an internally generated intangible asset:

a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and

c) expenditure on training staff to operate the asset.

Cannot be capitalised

Recognition and Initial Measurement

Example

- An entity is developing a new production process.
- During 2005, expenditure incurred was $1,000, of which

a) $900 was incurred before 1 Dec. 2007 and

b) $100 was incurred between 1 Dec. 2007 and 31Dec. 2007

- The entity is able to demonstrate that, at 1 Dec.2007, the production process met the criteria for

recognition as an intangible asset.

- The recoverable amount of the know-how embodied in the process is estimated to be $500.
- During 2008, expenditure incurred is $2,000.
- At the end of 2008, the recoverable amount of the know-how embodied in the process is estimated to be $1,900

Expensed

Capitalised

No impairment

Capitalised

Impairment = $200

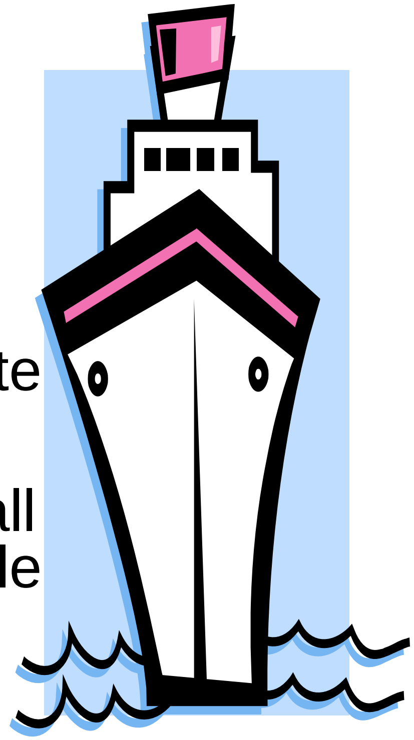
Recognition of Expense

- Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

a) part of the cost of an intangible asset that meets the recognition criteria; or

b) acquired in a business combination and cannot be recognised as an intangible asset.

If this is the case, this expenditure (included in the cost of the business combination) shall form part of the amount attributed to goodwill at the acquisition date



- Expenditure initially recognised as an expense shall not be recognised as part of the cost of an intangible asset at a later date

Measurement after Recognition

- An entity shall choose either:

Cost Model

Revaluation Model

• If an intangible asset is accounted for using the revaluation model, – all the other assets in its class shall also be accounted for using the same model unless there is no active market for those assets.

An active market is a market in which all the following conditions exist:

a) the items traded in the market are homogeneous;
b) willing buyers and sellers can normally be found at any time; and
c) prices are available to the public.

Measurement after Recognition

Cost Model

After initial recognition, an intangible asset shall be carried at
its cost less any accumulated depreciation and any accumulated impairment losses

Revaluation Model

- After initial recognition, an intangible asset shall be carried at *a revalued amount*, being its fair value at the date of the revaluation, *less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.*
- For revaluations under IAS 38, fair value shall be determined by reference to an active market.
- Revaluations shall be made with regularity

Measurement after Recognition

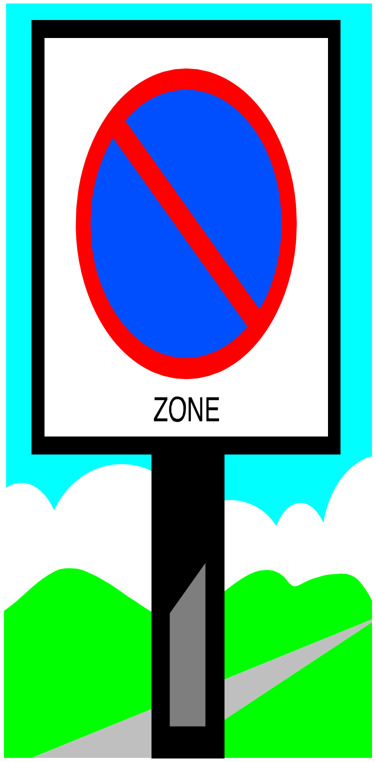
Revaluation Model

Application of revaluation model

• The revaluation model does not allow:

a) the revaluation of intangible assets that have not previously been recognised as assets; or

b) the initial recognition of intangible assets at amounts other than cost



Measurement after Recognition

Revaluation Model

Frequency of revaluations

- The frequency of revaluations depends on the volatility of the fair values of the intangible assets being revalued.
- If the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary.

Measurement after Recognition

Revaluation Model

Same as
IAS 16 PPE

Recognition of revaluation surplus or deficit

- If carrying amount is increased as a result of a revaluation,

– the increase shall be credited directly to equity under the heading of revaluation surplus.

– However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss

- If carrying amount is decreased as a result of a revaluation,

– the decrease shall be recognised in profit or loss.

– However, the decrease shall be debited directly to equity under the heading of revaluation surplus to the extent of any credit balance in the revaluation surplus in respect of that asset.

Measurement after Recognition

Revaluation Model

Realisation of revaluation surplus

• In such case (surplus realised as the asset is used by an entity), the amount of the surplus realised is the difference between

– amortisation based on the revalued carrying amount of the asset and

– amortisation that would have been recognised based on the asset's historical cost.

Dr Revaluation surplus
(amortisation based on the revalued carrying amount less amortisation based on the asset's historical cost)
Cr Retained earnings

• Transfers from revaluation surplus to retained earnings are not made through income statement.

Measurement after Recognition

Example

- Transystems designs websites and writes bespoke software.
- Further, during the current financial period, the group has capitalised its domain names acquisition costs of $1 million within tangible non current non-assets, and revalued the asset to $3 million.

- In order to meet the definition of an Intangible Asset, IAS 38 requires identifiability, control and the existence of future economic benefits. It would appear that the domain names should be shown as an intangible asset. Further on actual recognition, the intangible asset should be measured at cost.
- Any subsequent revaluation using the Revaluation Model is only possible if there is an active market for the intangible asset.
- The definition of an ‘active market’ is quite stringent to the extent that very few intangibles have such a market.
- Thus, the domain name costs should be shown at cost under intangible assets and amortised/reviewed for impairment.
- The revaluation model cannot be used in this case.

Useful Life

- No matter, which of the following model is used by an entity:

Cost Model or **Revaluation Model**

- IAS 38 sets out that an entity shall assess whether the useful life of an intangible asset is

Finite or Indefinite

If finite
– the length of, or number of production or similar units constituting, that useful life.

An intangible asset has an indefinite useful life when
– based on an analysis of all of the relevant factors
– there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Useful Life

- The accounting for an intangible asset is based on its useful life.
  - Many factors are considered in determining the useful life of an intangible asset.

Finite

Amortisation required

Indefinite

Amortisation not required

Useful Life

- The term ‘indefinite’ does not mean ‘infinite’.
- The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset’s useful life, and the entity’s ability and intention to reach such a level.

Finite | Indefinite

- A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance.

Useful Life

Intangible asset arising from contractual or other legal rights

- The useful life of such intangible asset

– shall not exceed the period of the contractual or other legal rights,

– but may be shorter depending on the period over which the entity expects to use the asset.

Finite | Indefinite

- If the contractual or other legal rights can be renewed, the useful life of the intangible asset shall include the renewal period only if

– there is evidence to support renewal by the entity without significant cost.

Useful Life

Example

• A direct-mail marketing company

– acquires a customer list and

– expects that it will be able to derive benefit from the information on the list for at least one year, but no more than three years.

• The customer list would be amortised over management's best estimate of its useful life (say 18 months).

• Although the direct-mail marketing company may intend to add customer names and other information to the list in the future, the expected benefits of the acquired customer list relate only to the customers on that list at the date it was acquired.

• The customer list also would be reviewed for impairment in accordance with IAS 36 *Impairment of Assets*

• by assessing at each reporting date whether there is any indication that the customer list may be impaired

Useful Life

Example

- An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate net cash inflows for only 30 more years.

- The copyright would be amortised over its 30-year estimated useful life.
- The copyright also would be reviewed for impairment in accordance with IAS 36
- by assessing at each reporting date whether there is any indication that it may be impaired.

Case

Useful Life

Unilever Pakistan Limited

Intangibles having indefinite useful life are stated at cost less accumulated impairment. Carrying amounts of intangibles are subject to impairment review at each balance sheet date and where conditions exist, impairment is recognised. The determination of recoverable amounts is based on value-in-use calculations that require use of judgment to determine net cash flows arising from continuing use and applicable discount rate.

The useful lives of intangible assets are reviewed at each balance sheet date to determine whether events and circumstances continue to support an indefinite useful life assessment for the asset.

Finite Useful Life

Amortisation

- The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life.
- Amortisation

– shall begin when the asset is available for use,

•– shall cease at the earlier of

- the date that the asset is classified as held for sale (or included in a disposal group held for sale) in accordance with IFRS 5 and
- the date that the asset is derecognised

Finite Useful Life

Amortisation

Amortisation Method

- The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
  - If that pattern cannot be determined reliably, the straight-line method shall be used.
- The amortisation charge for each period shall be recognised in profit or loss unless this or another Standard permits or requires it to be included in the carrying amount of another asset.

Say PPE or Inventories

Finite Useful Life

Amortisation

Amortisation Method

Residual Value

- The residual value of an intangible asset is the estimated amount that
  - an entity would currently obtain from disposal of the asset,
  - after deducting the estimated costs of disposal, if the asset were

- The residual value of an intangible asset with a finite useful life shall be assumed to be zero unless:

a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

b) there is an active market for the asset and:

i) residual value can be determined by reference to that market; and

ii) it is probable that such a market will exist at the end of the asset's useful life

Finite Useful Life

Example

Assessing the useful lives of intangible assets

- The product protected by the patented technology is expected to be a source of net cash inflows for at least 15 years.
- The entity has a commitment from a third party to purchase that patent in 5 years for 60% of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in 5 years.

The patent would be

- amortised over its 5-year useful life to the entity with a residual value equal to the present value of of the patent's fair value at the date it was acquired.
- reviewed for impairment in accordance with IAS 36 by assessing at each reporting date whether there is any indication that it may be impaired.

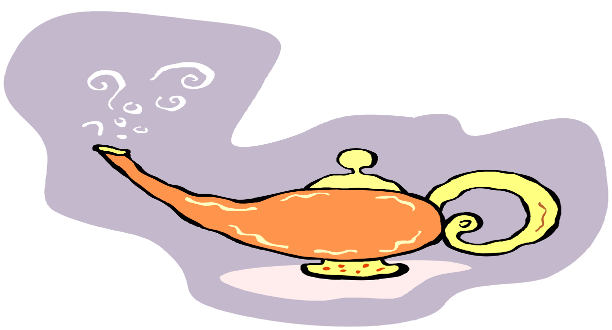
Indefinite Useful Life

- An intangible asset with an indefinite useful life shall not be amortised.
- In accordance with IAS 36 *Impairment of Assets*

– an entity is required to test an intangible asset with an indefinite life for impairment by comparing its recoverable amount with its carrying amount

a) annually, and

b) whenever there is an indication that the intangible asset may be impaired



Indefinite

Indefinite Useful Life

Example

Assessing the useful lives of intangible assets

- The broadcasting licence is renewable every 10 years if the entity
  - provides at least an average level of service to its customers and
  - complies with the relevant legislative requirements.
- The licence may be renewed indefinitely at little cost and has been renewed twice before the most recent acquisition.
- The acquiring entity intends to renew the licence indefinitely and evidence supports its ability to do so.
- Historically, there has been no compelling challenge to the licence renewal.
- The technology used in broadcasting is not expected to be replaced by another technology at any time in the foreseeable future.
- Therefore, the licence is expected to contribute to the entity’s net cash inflows indefinitely.

Indefinite Useful Life

Example

Assessing the useful lives of intangible assets

- The broadcasting licence would be treated as having an indefinite useful life because it is expected to contribute to the entity’s net cash inflows indefinitely.
- Therefore, the licence would not be amortised until its useful life is determined to be finite.
- The licence would be tested for impairment in accordance with IAS 36
  - annually and
  - whenever there is an indication that it may be impaired

Indefinite Useful Life

Example

Assessing the useful lives of intangible assets

- Same as previous example
- The licensing authority subsequently decides that it will no longer renew broadcasting licences, but rather will auction the licences.
- At the time the licensing authority's decision is made, the entity's broadcasting licence has three years until it expires.
- The entity expects that the licence will continue to contribute to net cash inflows until the licence expires.

- Because the broadcasting licence can no longer be renewed, its useful life is <u>no longer indefinite</u>.
- Thus, the acquired licence would be amortised over its remaining three-year useful life and <u>immediately tested for impairment</u> in accordance with IAS 36.

Impairment Losses

- To determine whether an intangible asset is impaired, an entity applies IAS 36 *Impairment of Assets*, that explains
  - when and how an entity reviews the carrying amount of its assets,
  - how it determines the recoverable amount of an asset and
  - when it recognises or reverses an impairment loss.
- In IAS 36, under normal situation

Triggering events

- An entity shall assess at each reporting date whether there is any indication that an asset may be impaired.
- If any such indication exists, the entity shall estimate the recoverable amount of the asset.

Impairment Losses

Triggering events

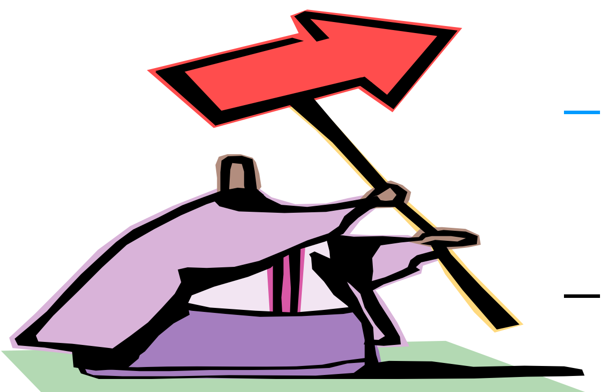
- However, irrespective of whether there is any indication of impairment, an entity shall also:

a) test

- an intangible asset with an indefinite useful life, or
- an intangible asset not yet available for use

– for impairment annually by comparing its

– carrying amount with its recoverable amount

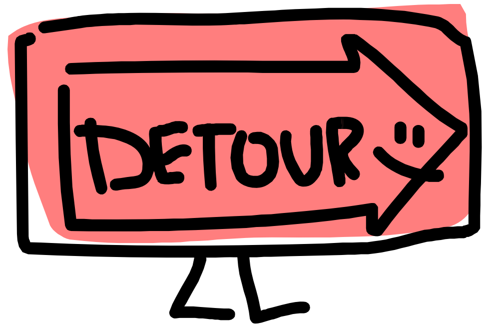


Retirements and Disposals

• An intangible asset shall be derecognised:

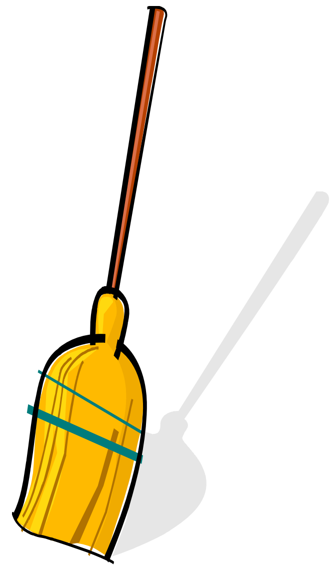
a) on disposal; or

b) when no future economic benefits are expected from its use or disposal.



• The gain or loss arising from the derecognition shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount

• It shall be recognised in profit or loss when the asset is derecognised (unless IAS 17 *Leases* requires otherwise on a sale and leaseback).



• Gains shall not be classified as revenue.

Disclosures

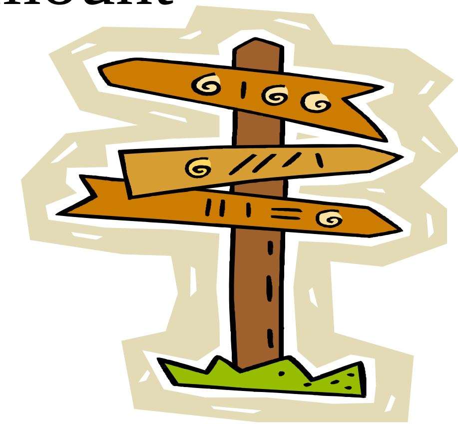
- IAS 38 introduces some additional disclosure requirements
- Changes are mainly amendments for the changes on finite and indefinite useful life
- Disclosures can be divided into disclosures for:

– General aspects for all intangible assets

– Intangible assets measured at revalued amount

– Research and development expenditure

– Other information



Rejoice!