Co-funded by the Erasmus+ Programme of the European Union

PASSFR.EU

A Digital Learning Platform for Generation Z: Passport to IFRS®

A Digital Learning Platform for Generation Z: Passport to IFRS®

IAS® Standard 38 Intangible Assets

Funded by the Erasmus+ Program of the European Union. However, European Commission and Turkish National Agency cannot be held responsible for any use which may be made of the information contained therein.

IAS® Standard 38 Intangible Assets

SCOPE AND KEY DEFINITIONS

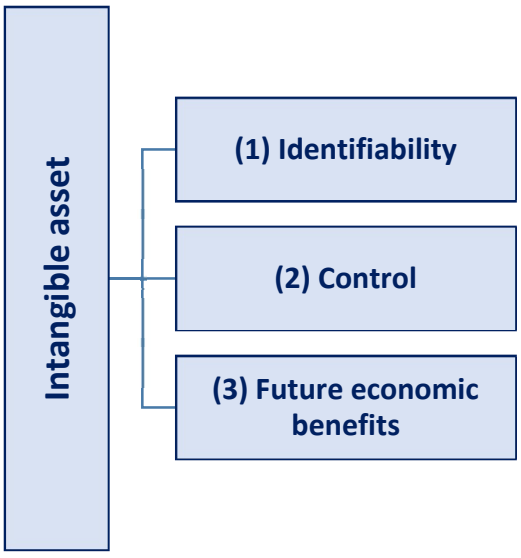
IAS Standard 38 Intangible Assets prescribes the accounting treatment of intangible assets that are not within the scope of another standard (for example, IAS Standard32 Financial Instruments: Presentation, IFRS Standard 6 Exploration for and Evaluation of Mineral Resources or IAS Standard 2 Inventories, among others).

An intangible asset is an identifiable, non-monetary asset without physical substance. IAS 38(8) refers to an asset to be a present resource that is controlled by the entity as a result of past events (for instance, purchase or production) and from which future economic benefits (inflows of cash or other assets) are expected. Of course, the definition of an asset has been changed in the 2018 revision of the Conceptual Framework for Financial Reporting (CFFR). According to this new definition, an asset is a present economic resource controlled by the entity as a result of past events (CFFR.4.3). An economic resource is a right that has the potential to produce economic benefits (CFFR.4.4).

Accordingly, IAS 38 outlines three critical features of an intangible asset, as follows (see Figure 1):

- identifiability;
- control (power to obtain benefits from the asset);
- future economic benefits (such as revenues or reduced future costs).

Fig. 1. Characteristics of Intangible assets



(1) Identifiability refers to (i) the characteristic of intangibles to be separated from other assets, sold, rented, exchanged either individually or together with an associated contract, or (ii) the characteristic of such assets to arise from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (IAS38.12).

(2) An entity controls an asset if it has the power to obtain the future economic benefits flowing from the underlying resource and to limit the access of others to those benefits. The capacity of an entity to control the future economic benefits arising from an intangible asset would normally result from legal rights. An entity controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain

confidentiality. In the absence of such legal rights, it is more difficult to demonstrate control. Nevertheless, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way. Market and technical knowledge may give rise to future economic benefits.

(3) The future economic benefits flowing from an intangible asset 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.

Examples of intangible assets include intangible assets related to marketing (such as trademarks, trade names), to customers (such as customer lists), to art (such as books, pictures, video materials), technology - based intangible assets (software, databases), and intangible assets based on contracts (licences, franchise agreements, use rights).

Under IAS 38, expenditure incurred on the following activities is not capitalised as intangible assets: start-up activities (e.g., legal and secretarial costs incurred in establishing a legal entity), training activities, advertising and promotional activities.

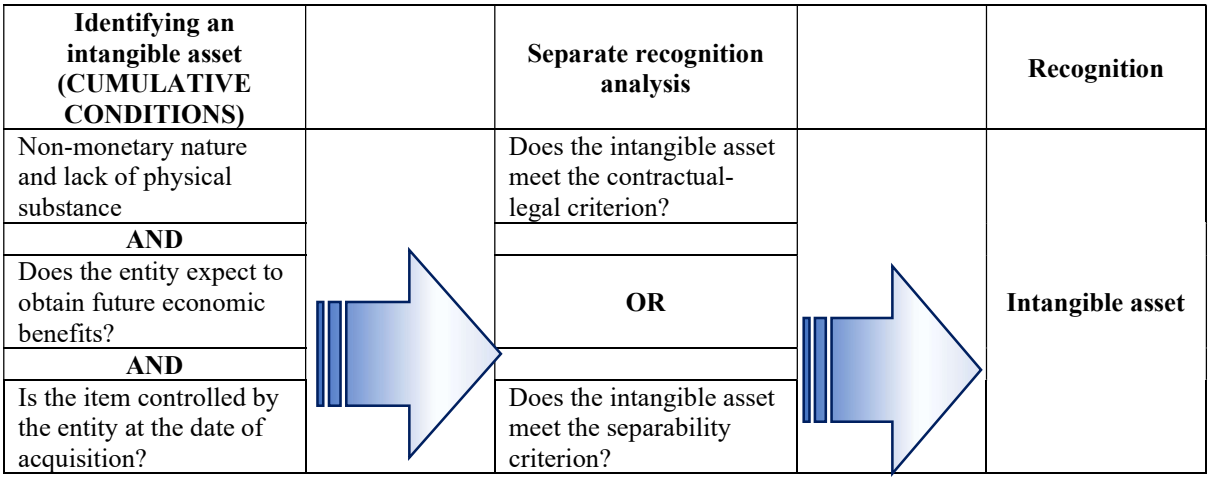
FUNDAMENTAL ISSUES

Intangibles can be obtained in various ways, the most common ones being resulting from a separate purchase, as part of a business combination and by self-creation (internal generation).

(1) Separate purchase of intangibles (acquisition cost)

The process of determining if an intangible asset meets the criteria to be separately identified may look like the one in Figure 2:

Fig. 2. Recognition process of intangible assets



For example, Saskia Ltd acquired a database used in managing its loyalty strategy, capturing information on customer demographics, preferences, relationship history and buying patterns. The database can either be sold or licensed. However, the entity has no intentions to do so, at least in the foreseeable future, because it will negatively impact its operating activity. The criteria are met: identifiability – the database is acquired separately; non-monetary characteristic – a separate database; future economic benefits - details about customers will be beneficial to the owner of the database; control of the benefits – access to

information based on acquisition contracts. The database will be recognized as an intangible in Saskia's financial reports.

(2) Purchase of intangibles as part of a business combination (fair value)

For example, Blue Project Co acquires Active Plus Co, a sports shoes producer, as part of its growth strategy. The brand *Active+* is very well known in the market and customers are very proud wearing its shoes. The *Active+* brand is associated with a particular shoe line. Blue Project Co intends to keep the brand for at least 5 years, until a new model will be introduced on the market. The *Active+* brand is identifiable, it meets the non-monetary characteristic, will bring future benefits (Blue Project Co may benefit from the status of the brand), and the entity controls the benefits (via the acquisition). Moreover, the brand meets the separability criterion (associated to a specific product). The brand can, therefore, be recognized as an intangible asset in the Blue Project Co.'s financial reports.

(3) Obtaining an intangible by self-creation (internal generation) (production cost)

For example, Tasoon Ltd internally developed a website for online selling. The project started on the 1st of March year N, when Tasoon Ltd bought the domain *tasoon.com*. The entity's IT team searched for the best alternative template for the website. On the 1st of May N, the budget for the website was approved, the management agreed on its content and pattern, the colours and the graphics of the website; on the same date, a set of pictures of the products, prepared by an external supplier, was ready to be uploaded. Two employees were assigned to online sales and website administration; previously, they completed a short-term course on website management. The website opened for online shopping on the 1st of July N. The website meets the identifiability (it is for online sale) and the non-monetary characteristics. Future benefits will be obtained and there is control of the benefits. The website can be recognized at cost as an intangible asset in Tasoon's financial reports.

INITIAL RECOGNITION

(1) Acquisition cost – separate purchase

IAS 38 mentions the elements of the acquisition cost (IAS38.27):

- ✓ purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and
- ✓ any directly attributable cost of preparing the asset for its intended use, such as:
  - the costs of employee benefits arising directly from bringing the asset to its working condition;
  - professional fees; and
  - the costs of testing whether the asset is functioning properly.

For example, Oscar Company purchased an inventory management software, for CU6,800. Oscar's software engineer installed the software. In order to integrate this software with financial reporting software, some specific features were designed by the supplier and invoiced at CU1,100. The inventory manager was trained by the supplier on how to use the application and it charged CU500 for this. Additionally, Oscar Co. bought a new server for CU3,800.

As the software meets the criteria to be recognized as an intangible in the entity's financial reports, its cost will be:

Acquisition - Cost of the software

	Value	Included	Comments
Price	CU6,800	YES	
Installation	n/a	YES	Oscar's engineer did the installation as part of their job
Specific features	CU1,100	YES	Costs to bring the software to the functioning mode required by Oscar Co.
Training	CU500	NO	Costs for staff training are excluded from the acquisition cost
Server	CU3,800	NO	Recognized as a tangible asset
TOTAL	**7,900 CU**		

Dr. Software 7,900
Cr. Non-current asset suppliers/Cash 7,900

Dr. Training costs 500
Cr. Non-current asset suppliers / Cash 500

Dr. Server 3,800
Cr. Non-current asset suppliers / Cash 3,800

(2) Acquisition cost – purchase as part of a business combination

Going back to the *Active +* brand acquired by the Blue Project Co., to be recognized in the entity's financial statements, Blue Project Co. computes the value of this brand by using a forecast of the sales, as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
Sales (in 000 CU)	1,400	1,900	1300	900	900
Discount rate (%)	6.1	6.1	6.1	6.1	6.1
Present value	1,320	1,688	1,088	710	669
Present value of the brand (000 CU)	**5,475**				

Dr. Brands 5,475,000
Cr. Cash 5,475,000

(3) Cost of production - self-creation (internal generation)

According to IAS 38, two phases are analysed when an intangible asset is internally generated:

(1). A research phase, and
(2). A development phase.

(1) the costs related to the research phase are not capitalised because the entity cannot demonstrate that an intangible asset exists and will generate probable future economic benefits (IAS38.55).

IAS 38 gives some examples of activities that are appropriate for the research phase:

- ✓ activities aimed at obtaining new knowledge;
- ✓ the search for, evaluation and final selection of, applications of research findings or other knowledge;
- ✓ the search for alternatives for materials, devices, products, processes, systems or services;
- ✓ the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services (IAS38.56).

(2) The costs related to the development phase are capitalised because the probability of future economic benefits is reasonable. The entity should demonstrate, however, that all of the following conditions are met:

(i) That the technical feasibility of completing the asset is ensured so that it will be available for use or sale.
(ii) That it has the intention to complete the intangible asset and use or sell it.
(iii) That it has the ability to use or sell the intangible asset.
(iv) That the intangible asset will generate probable future economic benefits, for example if the entity can 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.
(v) That it has enough availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
(vi) That it has the ability to measure reliably the expenditure attributable to the intangible asset during its development.

IAS 38 enumerates examples of activities that are appropriate for the development phase:

- ✓ the design, construction and testing of pre-production or pre-use prototypes and models;
- ✓ the design of tools, jigs, moulds and dies involving new technology;
- ✓ the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production;
- ✓ the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services (IAS 38.58).

For example, Dynamic Co. is developing a new production process. Expenditure in the amount of CU200,000 was incurred during the 20x1 year, of which CU125,000 before the 1st of December. Dynamic Co. can demonstrate that the production process met the criteria for recognition as an intangible asset as at 1st of December 20X1.

Dr. Research costs expense 125,000
Cr. Cash 125,000

Dr. Development costs 75,000
Cr. Cash 75,000

AMORTISATION

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life (IAS38.8). Amortisation is recognized as an expense in the statement of profit or loss. Intangibles are disclosed in the statement of financial position at their carrying amount, which is the difference between their cost and any accumulated amortisation and impairment losses.

There are three essentials here (see Figure 3):

Fig. 3 Essentials of intangible assets amortisation

SYSTEMATIC ALLOCATION	DEPRECIABLE AMOUNT	USEFUL LIFE
The entity should compute amortisation in a methodological approach that reflects the pattern of benefits obtained. For intangible assets, it is very likely that the straight-line method is the most appropriate one.	The entity should subtract the residual value of the asset when computing amortisation. The residual value, in many cases, will be nil (except for the case when an intangible asset will be sold to a third party at the end of its useful life)	Amortisation should be computed over the period of time over which the benefits are expected to be achieved. Based on contract provisions (contract-based assets) or a reliable estimation by management, based on: a typical product life cycle for the asset, technical, technological or commercial obsolescence, expected actions by competitors/ potential competitors, whether the useful life of the asset is dependent on the useful life of other assets

For example, Ruby Co acquired a franchise from Adele Inc. for CU2,000. The franchise agreement is for a period of 8 years. Ruby Co uses the straight-line method to amortise its intangible assets.

The annual amortisation = Depreciable amount / useful life = CU2,000 / 8 years = CU250

Dr. Amortisation expense 250
Cr. Accumulated amortisation of franchises 250

SUBSEQUENT MEASUREMENT OF INTANGIBLE ASSETS

In periods that are subsequent to the initial recognition, an entity can choose one of two measurement models: the cost model and the revaluation model (IAS38.72). The selected model (policy) must be applied consistently across each class of intangible assets (see Figure 4).

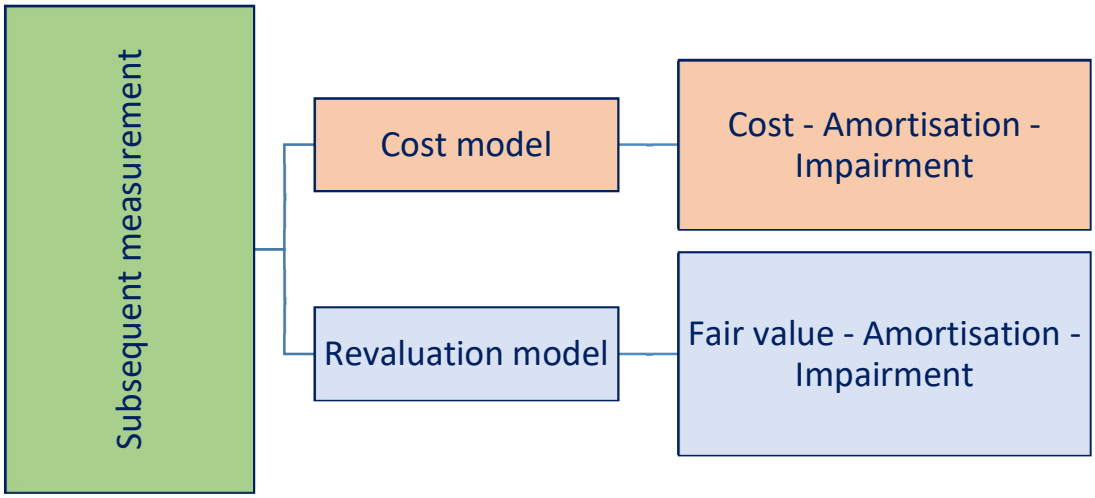


Fig. 4. Subsequent measurement of intangibles assets

When using the revaluation model, the fair value of intangible assets must be determined by reference to an active market (IAS38.75). An active market is defined as one in which transactions for the assets or liabilities take place with satisfactory regularity and volume as to provide pricing information on an ongoing basis. If no such market exists for the intangible asset (and in practice, due to the unique nature of intangibles, they rarely will exist) then the cost model must be adopted. Notable exceptions are taxi licences, fishing licences or production quotas.

For example, Smart City Ltd acquired a taxi licence 5 years ago for CU120,000. At the reporting date, the 31st of December 20N1, the carrying amount of this licence is CU24,000 and its fair value is CU75,000. At this date, Smart City Ltd intends to use the licence for an additional 10 years.

Carrying amount = CU24,000
Fair value = CU75,000
Revaluation surplus = CU51,000

a. cancelation of the accumulated amortisation

Cost = CU120,000
Carrying amount = CU24,000
Carrying amount = Cost – Accumulated Amortisation
CU24,000 = CU120,000 – Accumulated Amortisation => Accumulated Amortisation = CU96,000

Dr. Accumulated amortisation of licences 96,000
Cr. Licence 96,000

b. recognition of the revaluation surplus

Dr. Licence 51,000
Cr. Revaluation surplus 51,000

INTANGIBLES WITH AN INDEFINITE USEFUL LIFE

Intangible assets that have an indefinite useful life represent a special category of intangible assets. These assets are not amortised (as there is no finite useful life), but they are annually tested for impairment (see Figure 5). According to IAS 36, an impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount. The impairment loss is recognized immediately in the statement of profit or loss, unless it follows a revaluation which resulted in a revaluation surplus, in which case it reduces this item first.

Intangible assets with a FINITE useful life	Intangible assets with an INDEFINITE useful life
Have a limited period of benefits to the entity Amortisation is carried out on a systematic basis over the useful life of the intangible asset Considered for impairment when there are indications that the asset is impaired	No foreseeable limit to the period over which the asset is expected to generate benefits for the entity Not amortised Tested annually for impairment and whenever areindications of impairment

Fig. 5. Intangibles with finite vs. intangibles with indefinite useful life

For example, Blue Sky Company bought a broadcasting licence which is renewable every 10 years, on the condition that it complies with the legislative requirements. The licence may be renewed indefinitely at little cost and Blue Sky Company has renewed it once before. The current licence expires in five years and Blue Sky Company intends to renew it.

The licence should not be amortised as it appears that its useful life is indefinite and so it is expected to contribute to the Blue Sky Company's cash flows indefinitely. Blue Sky Company renewed the licence before and it intends to continue its operation in the foreseeable future. Therefore, Blue Sky Company will not recognise any amortisation expenses in respect to this licence, but it will test it annually for impairment.

DERECOGNITION OF INTANGIBLE ASSETS

Derecognition or disposal of intangible assets occurs when the benefits associated to them are no longer under the control of the entity. The gain or loss from derecognition (disposal) is the difference between the disposal proceeds and the carrying amount of the asset.

For example, Dino Co. sells a patent to Dark Inc. for CU4,000. The cost of the patent was CU33,000 and amortisation has accumulated to the selling date up to CU30,000.

Gain on the disposal = Proceeds from the sale – Carrying amount = CU4,000 – (33,000 – 30,000) = CU1,000

Dr. Cash	4,000	
Dr. Accumulated amortisation	30,000	
Cr. Patent		33,000
Cr. Gain on the disposal of patents		1,000

DISCLOSURE

An entity will disclose (IAS38.118):

- ✓ whether the useful lives of its intangible assets are indefinite or finite and, if finite, the useful lives, or the amortisation rates used;
- ✓ the amortisation methods used for intangible assets with finite useful lives;

- ✓ the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;
- ✓ the line item(s) of the statement of comprehensive income in which any amortisation of intangible assets is included;
- ✓ a reconciliation of the carrying amount at the beginning and end of the period (showing the increases, decreases, or assets classified as held for sale).

EXAMPLE

Goody Inc., which manufactures refrigerators, has developed during the current year two projects within its research and development department:

- Project A which consists in the design of a system for vocal control of the door of the refrigerators; and,
- Project B which consists in designing a type of compressor that reduces the electricity consumption of the refrigerators by 30%.

Project A: its technical feasibility cannot be demonstrated until the end of the current financial year and the budget is not yet approved.
Project B: the conditions for the recognition of development costs are met from the beginning of the current financial year.

The expenses of the research and development department in the current year were the following:

Details	**Project A (CU)**	**Project B (CU)**	**Other expenses**
Expenses with materials, consumables, etc.	30,000	60,000	
Expenses regarding subscriptions to specialised magazines	2,000	1,000	
Expenditure on attending conferences	12,000	10,000	
Expenditure on directly productive staff (researchers, engineers)	18,000	20,000	
Indirect expenses:			
- depreciation cost			1,200
- cleaning costs			1,000
- salary of the department manager			15,000
General expenses:			
- accounting department expenses			2,100
- human resources department expenses			800
- administrative department expenses			15,200

The depreciation and cleaning costs are distributed 30% to each project, the rest to the support departments (accounting, human resources, administration).

The salary of the department manager (CU15,000) is allocated 15% to project A and 25% to project B; the rest is considered as an administrative activity.

How will these costs be reflected in the entity's financial statements?

SOLUTION

Research costs
Project A does not meet the criteria for capitalization, therefore all the costs associated with it will be expensed (via the statement of profit or loss).

PROJECT A
Expenses with materials, consumables, etc. CU30,000
Expenses regarding subscriptions to specialised magazines CU2,000
Expenditure on attending conferences CU12,000
Expenditure on directly productive staff (researchers, engineers) CU18,000
Depreciation costs = CU1,200 x 30% = CU360
Cleaning costs = CU1,000 x 30% = CU300
Salary of the department manager = CU15,000 x 15% = 2,250
TOTAL = CU64,910

PROJECT B
Project B meets the capitalization criteria, therefore all the costs associated with it will be capitalised in the statement of financial position.

Expenses with materials, consumables, etc. CU60,000
Expenses regarding subscriptions to specialised magazines CU1,000
Expenditure on attending conferences CU10,000
Expenditure on directly productive staff (researchers, engineers) CU20,000
Depreciation costs = CU1,200 x 30% = CU360
Cleaning costs = CU1,000 x 30% = CU300
Salary of the department manager = CU15,000 x 25% = CU3,750
TOTAL = CU95,410