Accounting standard study group

CIMA Sri Lanka division

Study of SLAS 37: Intangible assets

We frequently come across resources which have no physical substance but seemingly create value to entities.

Companies often use significant funds to acquire, develop, maintain or enhance resources such as technical know-how, the design of new processes or systems, licences, intellectual property, market knowledge and trademarks which create value in terms of customer loyalty, market share, marketing rights etc.

But do all of the above, that we consider intangible and create value, constitute an intangible asset? Well, in a layman's term 'Yes', but all of the items above are not recognised as intangible assets according to accounting standards.

1. Objective

As per SLAS 37, the objective of the standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another.

Whilst having similar attributes to International Accounting Standard (IAS) 38 Intangible Assets, it should be noted that the revised aspects of IAS 38 does not yet form part of the local standard.

2. Scope

SLAS 37 should be applied by all enterprises in accounting for intangible assets, except:

- intangible assets that are covered by another Sri Lanka Accounting Standard,
- financial assets,
- mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources and
- intangible assets arising in insurance enterprises from contracts with policyholders.

3. Which standard to use? Key points to note

Some intangible assets may be contained in a physical object such as on a compact disc, document or film giving rise to physical substance. As such the asset would contain both intangible and tangible elements (e.g. computer software).

So should computer software be treated as a physical asset or as an intangible asset under this standard? In a situation such as the above, it usually boils down to judgment, as to which element; physical or intangible is more significant.

With regard to the example of software, if a machine cannot operate without specific software, then the software is treated as part of the machine and as such would be treated under SLAS 18 Property, Plant and Equipment. Conversely, if the software does not form an integral part of the related hardware, then the software would be considered as an intangible asset.

Another common complication is the treatment of expenditure on advertising, training, research and development. Although these activities are connected to an asset with physical substance, the physical element here becomes secondary to the intangible element. For example, research and development activities are directed to the development of knowledge. As such, because of the intangible component of 'knowledge' encompassed in such activities, the resources which are utilised on such activities would be treated according to SLAS 37 Intangible Assets.

4. Key definitions

Intangible asset: An identifiable non-monetary asset without physical substance. The standard specifically excludes monetary assets, as the treatment of such assets is specifically dealt under standards which cover financial assets.

The standard specifies three critical attributes for an asset to be considered as an intangible asset.

- Identifiability
- Control
- Future economic benefits

Identifiability: In simple terms it is the ability to identify an item individually without forming part of another item. Identifiability becomes important especially in the case of business combinations - as an intangible item if cannot be clearly distinguished will form part of the goodwill.

Does identifiability mean seperability? An asset is separable when an asset can be divided from the entity and the specific future economic benefits attributable to the asset can be rented, sold, exchanged or distributed, without effecting future economic benefits that flow from other assets used in the same revenue earning activity. However, according to the standard, separability is not a necessary condition for identifiability.

Let's look at an example: Legal rights are considered an intangible asset. However what if the legal right generated through a transfer at the point of acquiring a group of assets? In this instance you can clearly identify the intangible asset. However, sepearability will become an issue as a group of assets are acquired. Nevertheless, standard stipulates, separability is not a necessary condition. Therefore the legal right may be identified as an intangible asset.

Furthermore, if an asset generates future economic benefits only in combination with other assets, the standard still states the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control: In simple terms it is the power to obtain future economic benefits from a resource, and the power to restrict the access of others to those benefits.

As such 'control' would be easier to identify if it stems from legal rights. Legal rights give one access to economic benefits while restricting others from getting those benefits.

However what happens in the absence of legal rights? Does the absence of legal rights mean that the asset does not meet the 'control' criteria? Not necessarily. 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.

For example, an entity having a portfolio of customers may exert effort to enhance customer relationship and loyalty with the expectation that the customers will continue to trade with the entity. However, in the absence of legal rights to protect, or other ways to control the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the expected economic benefits from customer relationships, loyalty and market share.

Nevertheless, even in the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) can provide evidence that the entity is able to control the expected future economic benefits flowing from the customer relationships. Therefore, exchange transactions (which occur in the market) provide evidence that the customer relationships are separable meeting the 'control' criteria, though it does not have a legally enforceable right.

Future economic benefits: 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. This reduction in costs can be considered an 'economic benefit'.

5. Recognising an intangible asset

The recognition of an asset as an intangible asset requires an entity to demonstrate that the item meets the following criteria.

- The definition of an intangible asset
- The recognition criteria

The recognition criteria

SLAS 37 requires an entity to recognise an intangible asset, whether purchased or self-created if,

- it is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

If an intangible item does not meet both the definition and the criteria for recognition as an intangible asset, the standard requires the expenditure on this item to be recognised as an expense when it is incurred.

The standard provides examples of expenditure that will not give rise to an intangible asset.

- Expenditure on starting up an operation or a business (start-up costs)
- Expenditure on training
- Expenditure on advertising and/or promotion
- Expenditure on relocating or re-organising part or all of an enterprise

Expenditure on the above items should be recognised as an expense when it is incurred.

Can expenditure originally expensed be re-instated as an intangible asset at a future date?

No. The standard specifically prohibits an entity from subsequently reinstating an expenditure that was originally charged as an expense as an intangible asset on a later date.

Internally generated goodwill

According to the standard internally generated goodwill should not be considered as an asset. The standard takes the view that internally generated goodwill is not an identifiable resource controlled by the entity which can be measured reliably at cost. Therefore, it should not be recognised as an asset.

Internally generated intangible assets

Why is it sometimes difficult to assess whether or not an internally generated intangible item qualifies to be recognised as an intangible asset?

Because it is often difficult to;

- identify whether, and the point of time when, there is an identifiable asset that will generate probable future economic benefits; and
- determine the cost of the asset reliably. In some cases, the cost of generating an internal intangible asset cannot be distinguished from the cost of maintaining or enhancing the enterprise's internally generated goodwill or of running day-to-day operations.

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into the following phases.

- Research phase
- Development phase

Examples of activities that the standard considers as constituting a research phase are given below.

- 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; and
- the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices or products.

Examples of activities that the standard considers as constituting a development phase are given below.

- 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; and
- the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

What if one cannot distinguish between the two phases i.e. the research phase and the development phase?
If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the standard states the enterprise should treat the expenditure on that project as if it were incurred in the research phase.

Expenditure arising from research (or from the research phase of an internal project) should not be recognised as an intangible asset, but treated as an expense as and when it is incurred.

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following factors.

- The technical feasibility of completing the intangible asset so that it will be available for use or sale;
- its intention to complete the intangible asset and use or sell it;
- its ability to use or sell the intangible asset;
- how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should 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;
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
- its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Are internally generated brands, mastheads, publishing titles, customer lists and items similar in substance considered as intangible assets? No, because the standard takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items should not be recognised as intangible assets.

6. Measurement of intangible assets

Initial Measurement

An intangible asset should be measured initially at cost. In the event an intangible asset is acquired in a business combination (an acquisition) the cost of that intangible asset should be based on its fair value at the date of acquisition.

Subsequent to initial recognition

There are two methods of treatment.

a) Benchmark treatment

Initial value (recognition at cost)	xxxxx	
(-) Accumulated amortisation	(xxx)	
(-) Accumulated impairment losses	(xxx)	
Carrying value of intangible asset	**xxxxx**	

b) Alternate treatment

Revalued amount (based on fair value)			xxxxx
(-) Subsequent amortisation	(xxx)		
(-) Impairment losses		(xxx)	
Carrying value of intangible asset		**xxxxx**	

What is fair value? Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable and willing parties in an arm’s length transaction.

How do you assess fair value with reference to the 'alternate treatment method'? Fair value when using this approach can be determined only by reference to an active market. Therefore, this method of measurement can only be used if an active market is prevalent for the said intangible asset.

Though the standard stipulates an active market, it is uncommon for an active market to exist for an intangible asset (though this may occur). For example, an active market may exist for freely transferable taxi licences, fishing licences or production quotas.

Do active markets exist for acquired brands, newspaper mastheads, music and film publishing rights, patents or trademarks? No. The standard takes the view that active markets cannot exist for the above, because each of the above assets are unique. Therefore the alternate treatment method cannot be used with regard to these assets.

What do impairment losses mean? To determine whether an intangible asset is impaired, an enterprise compares the carrying amount of the asset reflected in the books of the company, with the recoverable amount of the said asset.

If, recoverable amount is less than the carrying amount of the asset it has an impairment loss.

7. Useful life of an intangible asset

Does the standard specify a maximum useful life for an intangible asset? The answer would be 'Yes' and a 'No'.

As per the standard, the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life not exceeding twenty years. The assumption here is that the useful life of an intangible asset will not exceed 20 years.

However, if control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset would be limited to the period of the legal rights, which could exceed the 20 year time line specified above.

For example, consider an enterprise which has purchased an exclusive right to generate hydroelectric power for sixty years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least sixty years.

How long should be the amortisation period? According to the standard the enterprise should amortise the right to generate power over sixty years, unless there is evidence that its useful life is shorter.

- **Amortisation method**

Does the standard specify a specific method of amortisation? The standard states a variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. As such the standard does not specify a particular method. However, the standard does specify that the amortisation method used should reflect the pattern in which the intangible asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation period and the amortisation method should be reviewed each financial year end, in the least.

- **Residual Value**

The depreciable amount of an asset is determined after deducting its residual value.

Do intangible assets have a residual value? According to SLAS 37, the residual value of an intangible asset should be assumed to be zero other in any of the following circumstances.

- There is a commitment by a third party to purchase the asset at the end of its useful life.
- There is an active market for the asset; and
    - residual value can be determined by reference to that market, and
    - it is probable that such a market will exist at the end of the asset's useful life.

Disclaimer

This document is compiled with the objective of presenting a basic overview of the respective Sri Lanka Accounting Standard, and does not construe professional advise in application of the standard. For specific application and understanding of all facets of the standard, the relevant Sri Lanka Accounting Standard issued by The Institute of Chartered Accountants of Sri Lanka should be referred.

Useful web-links pertaining to accounting standards

http://www.icasrilanka.com/Technical/Accounting%20Standards.html
http://www.iasb.org/Home.htm

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