Common Errors – Intangible Assets

Dean Ardern

Thursday 17 August 2023

Wolters Kluwer

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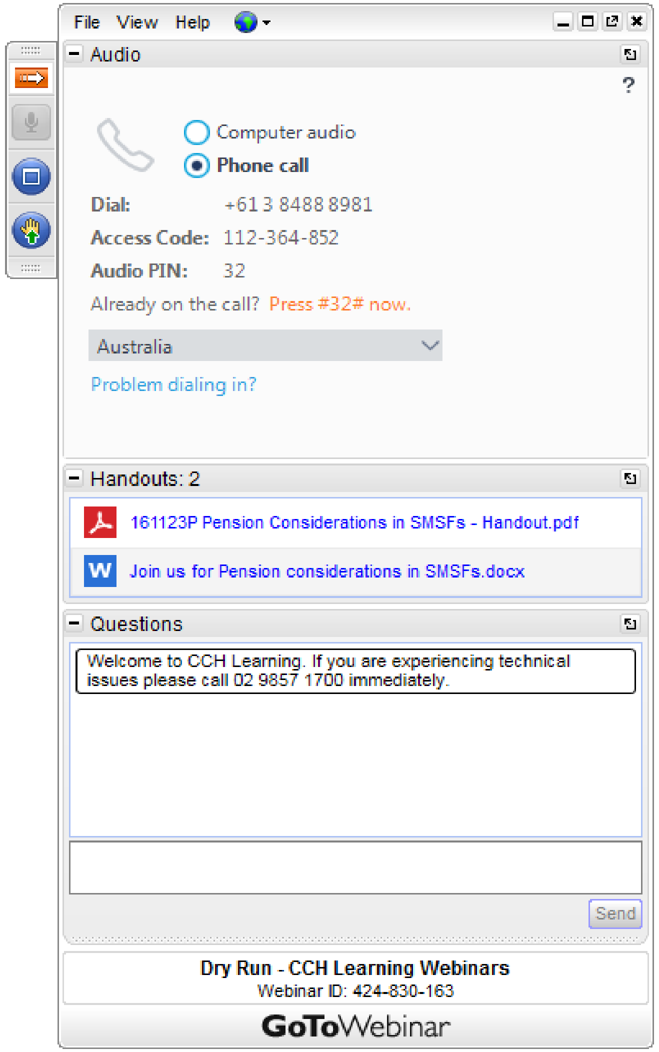

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Susannah Gynther
Moderator

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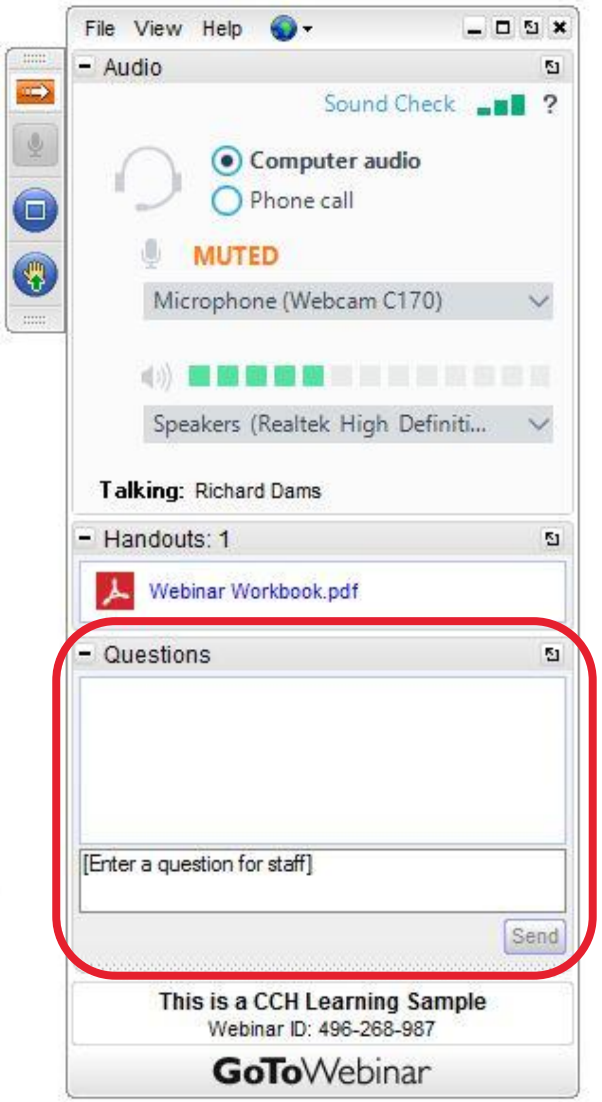

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Your Presenters

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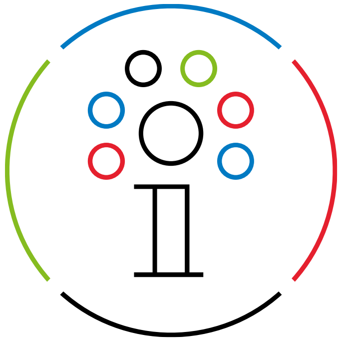
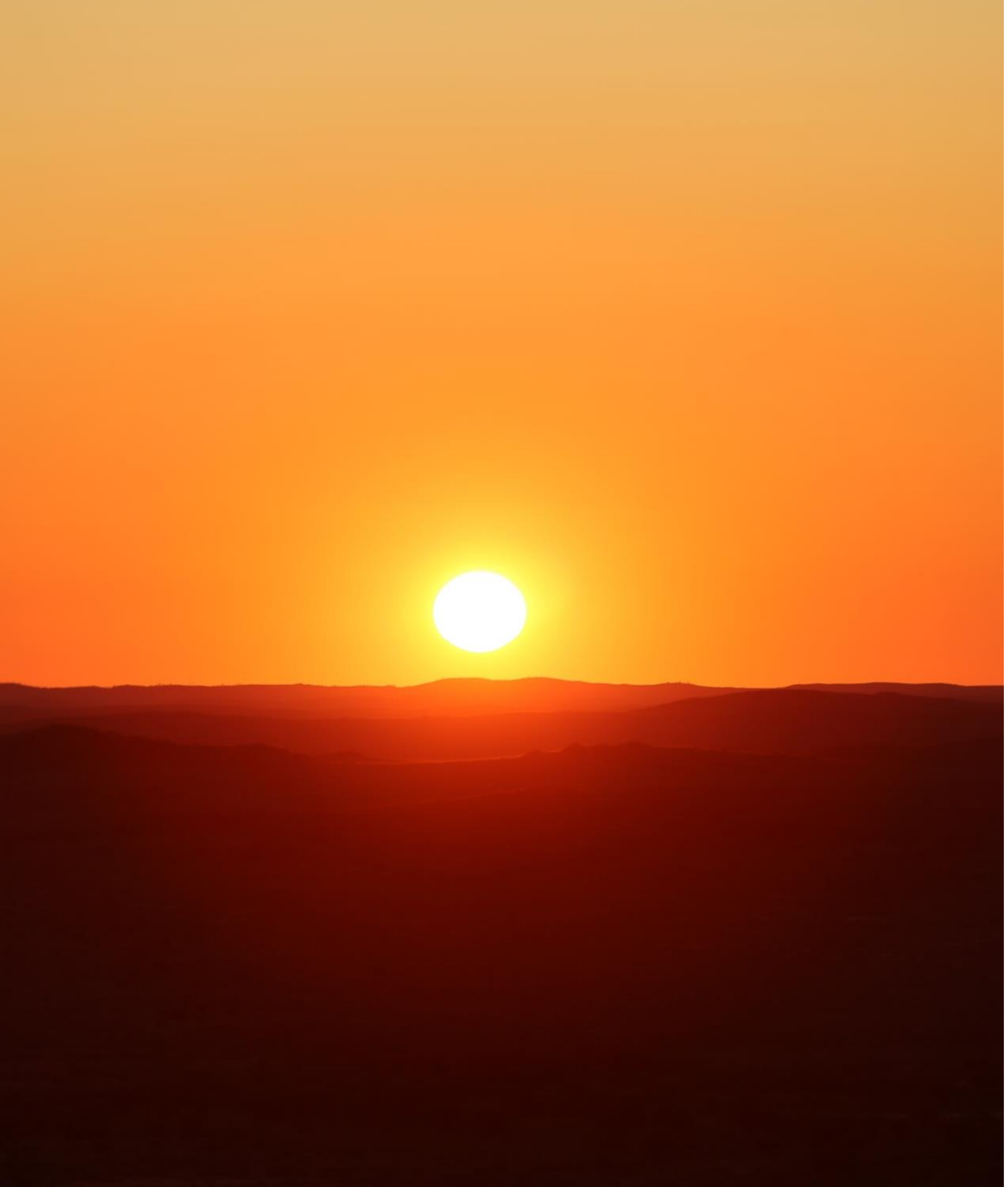
Today's session will cover



Common Errors – Intangible Assets

- Definitional criteria for an intangible asset
- Scope requirements of IAS 38
- Initial recognition and measurement
- Internally generated intangible assets
- Subsequent measurement
- Software as a service (SaaS)



ACKNOWLEDGEMENT OF COUNTRY

We would like to begin by acknowledging the Traditional Owners of the land on which we meet today, and pay our respects to Elders past, present, and emerging.

We extend that respect to Aboriginal and Torres Strait Islander peoples here today.

DEFINITION OF AN INTANGIBLE ASSET

IDEAS | PEOPLE | TRUST

INTANGIBLE ASSETS

They are everywhere!

'Not all of an entity's rights are assets of that entity—to be assets of the entity, the rights must both have the potential to produce for the entity economic benefits beyond the economic benefits available to all other parties (see paragraphs 4.14-4.18) and be controlled by the entity (see paragraphs 4.19-4.25). For example, rights available to all parties without significant cost—for instance, rights of access to public goods, such as public rights of way over land, or know-how that is in the public domain—are typically not assets for the entities that hold them.'

Para. 4.9 of the *Conceptual Framework for Financial Reporting*

'In many cases, the set of rights arising from legal ownership of a physical object is accounted for as a single asset. Conceptually, the economic resource is the set of rights, not the physical object. Nevertheless, describing the set of rights as the physical object will often provide a faithful representation of those rights in the most concise and understandable way.'

Para. 4.12 of the *Conceptual Framework for Financial Reporting*

DEFINITIONS

How would I know an intangible asset if I saw it?

An *intangible asset* is an identifiable non-monetary asset without physical substance. (IAS 38.8)

Identifiable	• Separable – capable of being separated or divided from the entity and sold, licensed, rented or exchanged • Arises from contractual or other legal rights, regardless of whether those rights are separable
Non-monetary	• Is an asset (embodies future economic benefits) • Not cash or an asset to be received in fixed or determinable amount of money
Non-physical	• May be contained in or on a physical substance, but the physical element is not the significant feature of the asset

DEFINITIONS

What is an intangible asset?

Required components under IAS 38.8

Intangible Asset

Identifiable
[IAS 38.11-12]

- **Separable**
- **Contractual**

Non-monetary - controlled by entity
[IAS 38.13-17]

Power to obtain future economic benefits from the resource (usually legal rights)

Without physical substance

Examples:

- Computer software
- Patents
- Copyrights
- Motion picture films
- Fishing licences
- Import quotas
- Franchise licence
- Customer lists*
- Customer or customer supplier relationships*
- Customer loyalty *
- Market share *
- Marketing rights *

*Note: examples with * unlikely to meet IAS 38 definition of intangible. However some may be recognised within goodwill in a business combination*

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DEFINITIONS

What is identifiability?

- ‘Identifiability’ distinguishes other intangible assets from goodwill
- An asset is identifiable if it is either:
  - Is separable, i.e. Is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability regardless of whether the entity intends to do so; or
  - Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations [IAS 38.12]

DEFINITIONS

What is control?

- An entity has control of an asset if:
  - It has the power to obtain future economic benefits flowing from the underlying resource
    - Can be demonstrated by legal rights that are enforceable in a court of law. For example, patents, copyright, licence agreements, etc
    - The absence of legally enforceable right does not preclude the exercise of control. For example, if there are exchange transactions for similar non-contractual rights, that would normally be sufficient to require separate recognition. Otherwise, considerable judgement may be required
  - It is able to restrict access of the economic benefits to others

DEFINITIONS

What is the significance of non-physical?

- Intangible assets do not have a physical substance
- Sometimes difficult to identify asset as tangible or intangible
  - Intangible asset contained in physical asset, for example:
    - Computer software contained on a CD or DVD
    - Film / hard drive containing a motion picture
    - Legal paperwork containing a licence, patent or copyright

Which element (tangible or intangible) is more significant?

- Software that is integral to running computer hardware – tangible asset since the software is required in order for the tangible asset to operate
- Prototype of asset – intangible asset since the prototype (physical asset) is incidental to the 'know how' (intangible asset) of making the asset

CHALLENGES WITH APPLYING THE DEFINITION OF INTANGIBLE ASSET

Why does it have to be so difficult?

- Changes in markets/products means items potentially caught within the scope of IAS 38 not ever anticipated:
  - Crytocurrencies
  - Digital tokens
  - Non-compete agreements
  - SaaS arrangements
- If I can identify a preparer has incurred a 'cost' as part of a larger transaction (such as a service agreement), and no separate goods or services can be attributed to that cost, is that sufficient to conclude the entity has acquired an intangible asset?
- In the process of continuous development/improvement, where does the existing asset end and new asset start?

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SCOPE OF IAS 38

SCOPE OF IAS 38 *INTANGIBLE ASSETS*

Items that are ‘intangible assets’ but are outside the scope of IAS 38

IAS 38 is applied in accounting for all intangibles, except:

- Intangible assets dealt with in other standards
  - Intangible assets held for sale in ordinary course of business (IAS 2)
  - Deferred tax assets (IAS 12)
  - Assets arising from employee benefits (IAS 19)
  - Intangible assets held under a lease agreement (discussed below)
  - Goodwill acquired in business combination (IFRS 3)
  - Deferred acquisition costs and other intangible asset arising form an insurer’s contractual rights under an insurance contract (IFRS 4)
  - Non-current intangible assets classified as held for sale (IFRS 5)

SCOPE OF IAS 38

Items that are ‘intangible assets’ but are outside the scope of IAS 38

- Financial assets (IAS 32)
- Exploration & Evaluation assets and expenditure of the development and extraction of mineral oils, natural gas and similar non-regenerative resources (IFRS 6)
- Assets arising from customer contracts (IFRS 15)

SCOPE OF IAS 38

What else is in and out of the scope of IAS 38?

- Standard applies to advertising, training, start-up research and development activities
- Research and development activities resulting in an asset with a physical element (e.g. prototype) accounted for in accordance with IAS 38 since the physical element is secondary to the intangible component (the know how)
- An entity can choose to apply IAS 38 or IFRS 16 *Leases* to leases of intangible assets other than rights held by a lessee under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights (which are required to be accounted for under IFRS 16)

INITIAL RECOGNITION AND MEASUREMENT

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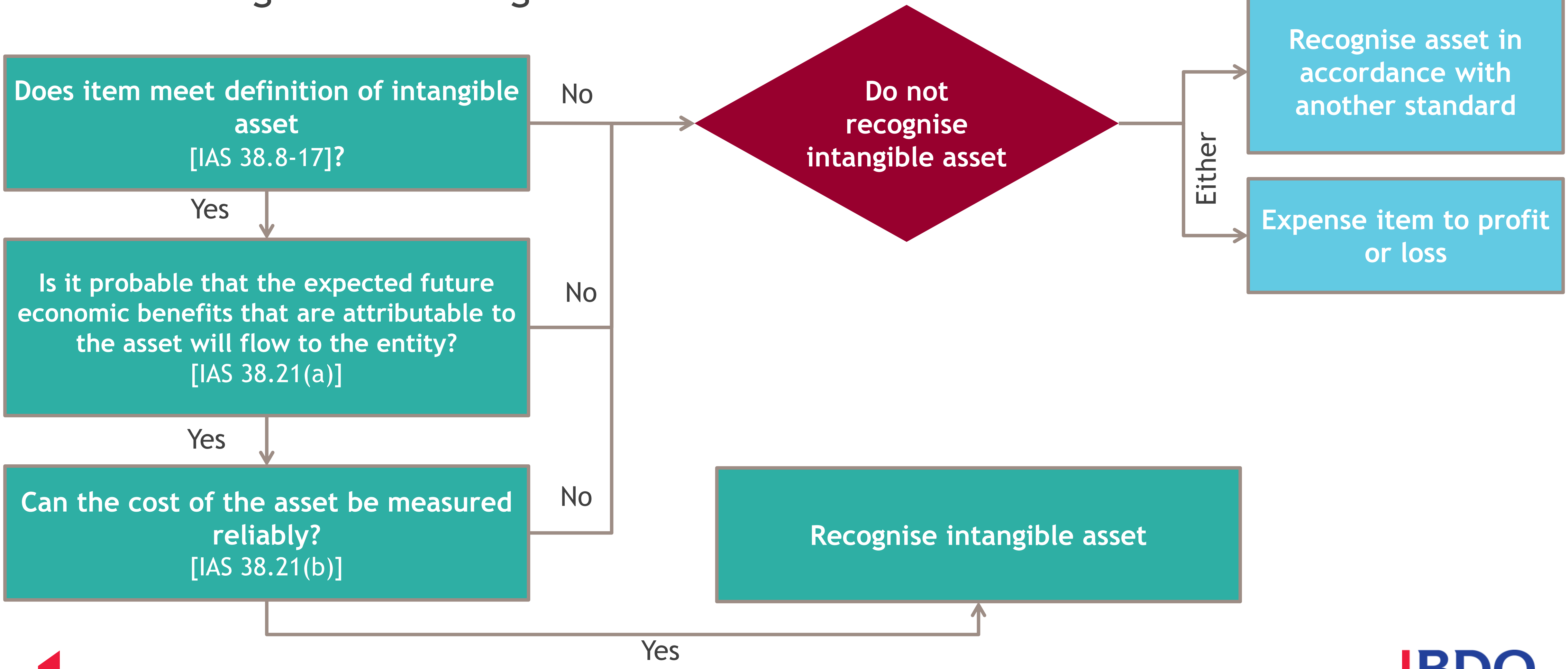
INITIAL RECOGNITION & MEASUREMENT

When to recognise an intangible asset



INITIAL RECOGNITION & MEASUREMENT

When to recognise an intangible asset

- An item that meets the definition of an intangible asset can only be recognised if:
  - It is probable that the expected economic benefits attributable to the asset will flow to the entity, and
  - The cost can be reliably measured
- ‘Probable’ not defined here but elsewhere is ‘more likely than not’
  - Test for definition and recognition is made each time potentially eligible expenditure incurred
  - Once expensed, cannot subsequently be reinstated as an asset
- It is not a policy choice – if the requirements are met, an asset must be recognised

INITIAL RECOGNITION & MEASUREMENT

When to recognise an intangible asset

- Initial measurement differs depending on if:
  - Separately acquired
  - Acquired as part of a business combination
  - Acquired by way of government grant
  - Acquired by an exchange of assets
  - Generated internally
- Initially recognised at cost – cash or cash equivalent paid, or fair value of consideration given at the time of acquisition
- If the nature of consideration is governed by another standard – the amount initially recognised is in accordance with that standard (e.g. share-based payments)

CHALLENGES WITH INITIAL RECOGNITION OF INTANGIBLE ASSETS

Why does it have to be so difficult?

- What kinds of challenges do you forsee for entities acquiring intellectual property and other intangible assets by issuing their own equity instruments?
- How would you measure the cost of a renewable energy credit (REC) that is a by-product of a production process that creates other saleable products?
- What kinds of challenges do you forsee for entities acquiring intellectual property by entering into royalty agreements?
- How would you account for an investment in a collaborative agreement that provides the investor with a (potential) right to any intangible assets arising under the agreement?

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INTERNALLY GENERATED INTANGIBLE ASSETS

INITIAL RECOGNITION & MEASUREMENT

Internally generated goodwill

Internally generated goodwill → **Is not identifiable**

- Is not separable
- Does not arise from contractual or legal rights

→ **Prohibited from recognition as an intangible asset**

INITIAL RECOGNITION & MEASUREMENT

Internally generated intangible assets prohibited from recognition as an intangible asset

- Brands
- Mastheads
- Publishing titles
- Customer lists
- Items similar in substance to above
- Trained workforce

→

Cannot be distinguished from costs of developing business

(i.e. Similar to internally generated goodwill)

→

Do not recognise as intangible assets

INITIAL RECOGNITION & MEASUREMENT

Internally generated intangible assets

Costs associated with internal generation of intangible asset

Classify as part of either:

- **Research phase**
  - Expense expenditure when incurred
- **Development phase**
  - Recognise as part of cost of intangible asset, so long as it demonstrates:
    - Technical feasibility of completing asset
    - Intention to complete asset
    - How it will generate probable future economic benefits
    - Availability of resources to complete asset
    - Ability to reliably measure expenditure on asset

Where entity cannot determine classification as either research phase or development phase, all expenditure treated as if it were part of research phase

INITIAL RECOGNITION & MEASUREMENT

Internally generated intangible assets

Research phase

- Original and planned investigation undertaken to gain new scientific or technical knowledge and understanding (earlier stages of a project)
- Examples include:
  - Search for new knowledge
  - Search for alternative materials, devices, products, processes, systems or services
  - Formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services
- Accounting treatment = all research costs are expensed

INITIAL RECOGNITION & MEASUREMENT

Internally generated intangible assets

Development phase

- 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
- Development stage is further advanced than research stage – entity can often identify and demonstrate that asset will generate future economic benefits
- Examples include:
  - Design and construction of a pilot plant/ design of pre-production prototypes
  - Design of tools, jigs, moulds and dies involving new technology
  - Design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services

INITIAL RECOGNITION & MEASUREMENT

Internally generated intangible assets

Development phase

- Capitalise development expenditure as intangible asset if all following criteria are met
  a) Technical feasibility of completing the intangible asset for use or sale
  b) Intention to complete intangible asset
  c) Ability to use or sell the intangible asset
  d) How the intangible asset will generate probable future economic benefits
  e) Availability of adequate technical, financial and other resources to complete the development
  f) Ability to reliably measure expenditure on the intangible asset

INITIAL RECOGNITION & MEASUREMENT

Internally generated intangible assets

Development phase

- For many entities that develop intangible assets (e.g. Pharmaceuticals):
  - It is often difficult to obtain funding for the development of the intangible asset until the point the technology has been proven to be feasible
  - The economic feasibility is often established very late in the development phase (often once regulatory approval is obtained)
  - Only a small portion of the development costs can ever be capitalised (difficulty in meeting IAS 38.57 recognition criteria)

Remember the entity is prohibited from retrospectively capitalising an intangible asset once it is proved to be feasible

INITIAL RECOGNITION & MEASUREMENT

Cost of internally generated intangible assets

Cost of internally generated intangible asset

- Cost of internally generated asset is the sum of expenditure incurred by entity from the date the intangible asset first meets the recognition criteria in paragraphs 21, 22 and 57 (i.e. when development phase commences)
- Any expenditure incurred on an internally generated intangible asset that had previously been expensed prohibited from being included as part of cost of asset
- Capitalise all directly attributable costs that are necessary to create, produce and prepare the asset to be capable of being operated in the manner intended by management

INITIAL RECOGNITION & MEASUREMENT

Cost of internally generated intangible assets

Examples of directly attributable costs include:

a) Costs of materials and services used or consumed in generating the intangible asset
b) Costs of employee benefits (IAS 19) arising from the generation of the intangible asset
c) Fees to register a legal right, and
d) Amortisation of patents and licences that are used to generate the intangible asset

INITIAL RECOGNITION & MEASUREMENT

Cost of internally generated intangible assets

Examples of costs that are not costs of an internally generated intangible asset:

- Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use, e.g.
  - Advertising
  - Market research
  - Recruitment
  - Cost of CEO
  - Public relations
  - Business development costs
  - Lobbyists
- Identified inefficiencies and initial operating losses incurred before the asset achieves planned performance
- Expenditure on training staff to operate the asset

CHALLENGES WITH RECOGNISING INTERNALLY GENERATED INTANGIBLE ASSETS

Why does it have to be so difficult?

- What is the ‘tipping point’ from research phase to development phase?
- On what basis do I assess whether the costs incurred to date in an in-process development project are likely to generate future economic benefits?
- On what basis do I determine whether costs incurred during the development phase are reliably measurable?
- Can IAS 38 accommodate ‘Agile’ software development methodologies (‘sprints’)?
- Can I capitalise interest costs to development projects?
- Can the resources acquired to conduct a research project be initially capitalised or do they need to be expensed when acquired?

SUBSEQUENT MEASUREMENT

SUBSEQUENT MEASUREMENT

Cost model

After initial recognition:

Carrying Value of Intangible Asset	=	Cost	Less	Accumulated amortisation	Less	Accumulated impairment losses

SUBSEQUENT MEASUREMENT

Revaluation model

After initial recognition

Carrying Value of Intangible Asset	=	A revalued amount *(fair value at date of revaluation)*	Less	***Subsequent*** **accumulated amortisation**	Less	***Subsequent*** **accumulated impairment losses**

Note: where only part of item recognised as asset (initially at cost) due to timing of when recognition criteria initially met, revaluation may be applied to whole of asset

SUBSEQUENT MEASUREMENT

Revaluation model

Revaluation model can only be applied to intangible assets

IF

the value of the item can be determined by reference to a homogenous **active market**

An active market is a… *market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.* (IFRS 13 *Fair Value Measurement*)

SUBSEQUENT MEASUREMENT

Revaluation model

Active markets

- In certain jurisdictions homogenous active markets may exist for:
  - Fishing licences
  - Taxi licences
  - Production quotas
- An active market cannot exist for unique assets such as:
  - Brands
  - Newspaper mastheads
  - Music
  - Film publishing rights
  - Patents or trademarks

SUBSEQUENT MEASUREMENT

Revaluation model

Fair value of intangible asset - active market

- If an intangible asset in a class of intangible assets cannot be revalued because there is no active market then the asset is carried at cost less accumulated amortisation and impairment losses
- Active market for revalued intangible no longer exists (permanently or temporarily)
  - Cease revaluing intangible asset at date market becomes inactive. The intangible asset is subsequently accounted for by reducing the carrying value by subsequent accumulated amortisation and any subsequent accumulated impairment losses
  - Indicator of impairment – test in accordance with IAS 36 *Impairment of Assets*
  - If active market exists at subsequent measurement date, revaluation model applied from that date

CHALLENGES WITH SUBSEQUENT ACCOUNTING FOR INTANGIBLE ASSETS

Why does have to be so difficult?

- What do I need to consider when determining the useful life of an intangible asset?
  - Do I only factor in the period over which the asset will contribute directly to cash flows?
  - Do I factor into the useful life the estimated time it will take to develop a replacement asset?
  - Do I factor in the possibility that I might dispose of the asset before the end of its useful life?
- When is an intangible asset available for use?

- In determining whether an intangible asset has an indefinite useful life, what do I consider?
  - The nature of the asset? For instance, could a customer relationship have an indefinite useful life?
  - Typical product life cycle for the asset?
  - Level of maintenance/marketing required to maintain the asset's operating capability?
  - Whether useful life is dependent on useful life of other assets?
  - Barriers to output market entry?
  - Stability of the output market?
  - Capacity to continually renew?
  - The impact of expected technological change?

SOFTWARE AS A SERVICE

SAAS IMPLEMENTATION COSTS

Background

- Type of arrangement: Software as a Service (SaaS)
- Rights conveyed by the contract: Right to receive access to the supplier's software over the contract term
- The right to receive access does <u>not provide the customer with a software asset</u> and, therefore, the <u>access to the software is a service</u> that the customer receives over the contract term
- Costs incurred by the customer:

<u>Configuration costs:</u>
Setting of various 'flags' or 'switches' within the application software, or defining values or parameters, to set up the software's existing code to function in a specified way.

<u>Customisation costs:</u>
Modifying the software code in the application or writing additional code. Customisation generally changes or creates additional functionalities within the software.

SAAS IMPLEMENTATION COSTS

Question 1 – Recognise intangible asset?

Agenda decision

- In the fact pattern, the supplier controls the application software to which the customer has access
- The assessment of whether configuration or customisation of that software results in an intangible asset for the customer depends on the nature and output of the configuration or customisation

If the customer does not control the software being configured or customised and those configuration or customisation activities do not create a resource controlled by the customer that is separate from the software → The customer would not recognise an intangible asset (more commonly observed scenario)

If the arrangement results in, for example, additional code from which the customer has the power to obtain the future economic benefits and to restrict others' access to those benefits → To determine whether to recognise the additional code as an intangible asset, the customer assesses whether the additional code is identifiable and meets the recognition criteria in IAS 38

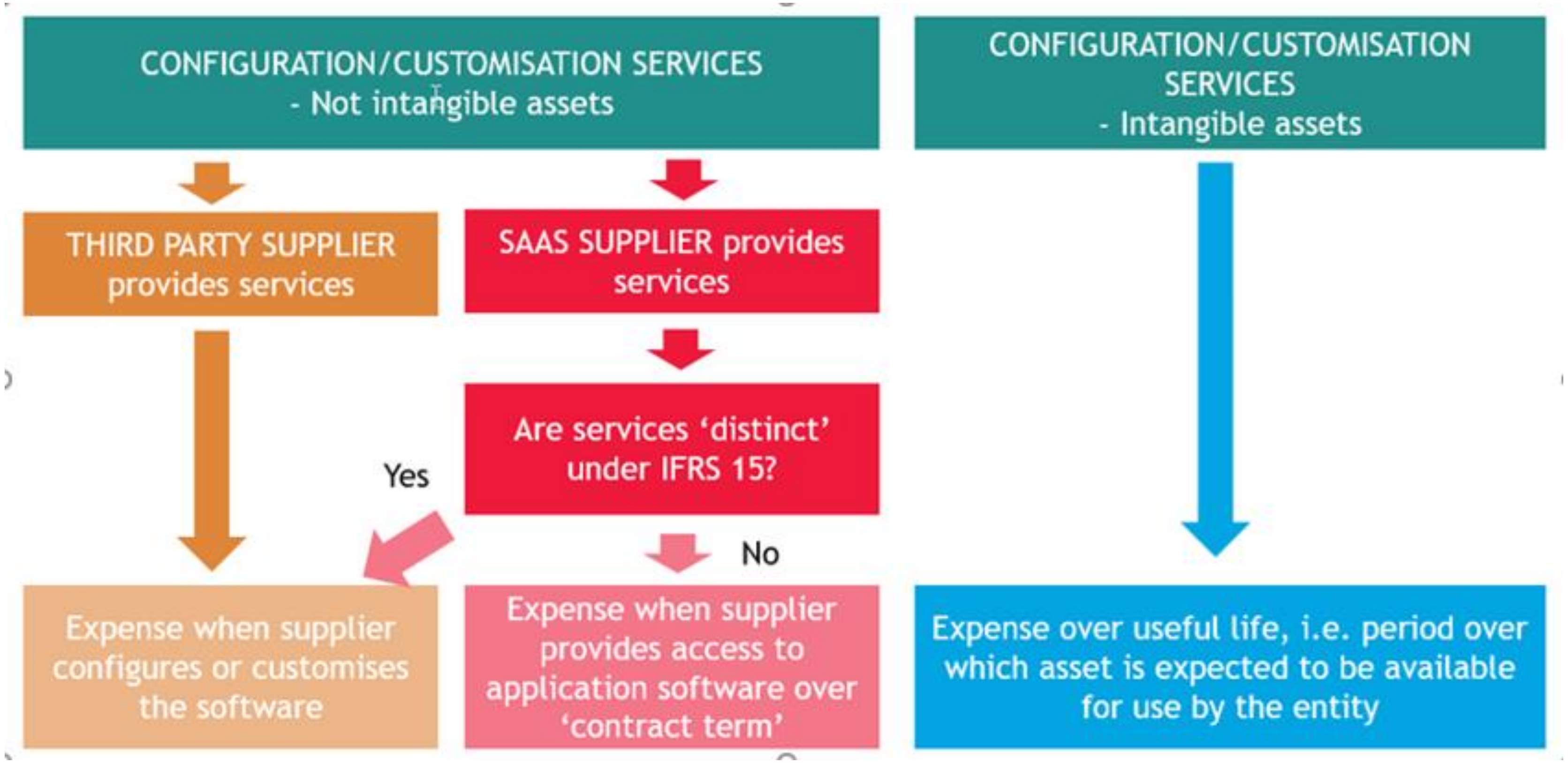
SAAS IMPLEMENTATION COSTS

IFRIC addressed two questions

Question

Q2: If an intangible asset is not recognised, how does the customer account for the configuration or customisation costs?

SAAS IMPLEMENTATION COSTS – DO YOU NEED TO WRITE THESE OFF?



Questions

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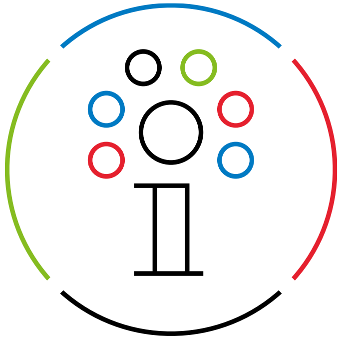

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Susannah Gynther
Moderator

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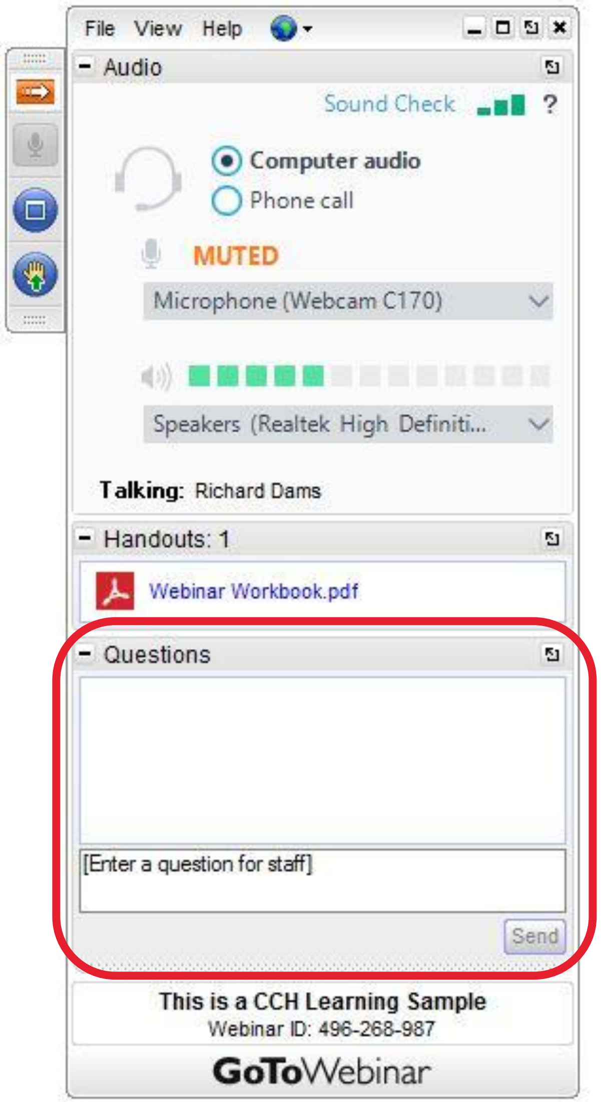

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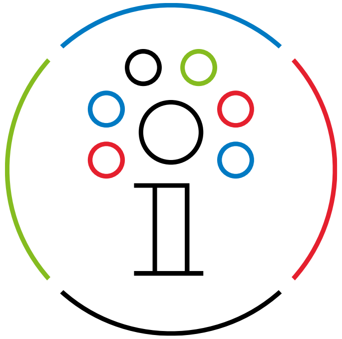

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- 29 August – ChatGPT – Plugins and Code Interpreter
- 30 August – Incapacity Planning and the Role of A Financial Advisor
- 31 August – Aged Care Forms, Fees and Funding

Questions

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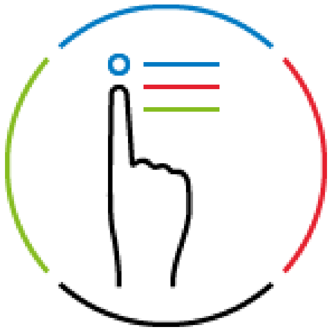

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