

Comparison of ifrs and u.s gaap in relation to intangible assets



1. Introduction

Businesses have never been as globalised as they are today. Numerous corporations from developed, newly industrialised and developing countries operate on a global basis and need to create financial statements using the accounting practices of their home country, as well as those existing in their areas of operations. The divergence in accounting practices of different countries creates the need for the preparation of separate financial and accounting statements and subsequent reconciliation of differences. The international accounting fraternity is now steadily moving towards global commonality in accounting practices and procedural reporting. The International Accounting Standards Board (IASB) has been working towards convergence of global accounting standards. Its mission is to develop and enforce a single set of global accounting standards, based on preparation of high quality, transparent and comparable financial statements for local and global users.

The IASB has been working on compiling a stable set of International Financial Reporting Standards (IFRS) for first time users. The IFRS was mandated for all publicly listed companies in the European Union in 2005 and has also been adopted by other countries like Australia. The IASB has also been working very closely with the US Financial Accounting Standards Board (FASB), since 2002, to bring about convergence between US GAAP and the IFRS. However, while significant work has been done on harmonising IFRS with US GAAP and many pending issues are being currently addressed, a number of accounting topics are still treated differently by these two systems.

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A number of differences continue to remain in the accounting treatment of intangible assets. Intangibles have been defined in various ways. Essentially they comprise of assets that do not have physical presence and are represented by items like goodwill, brands and patents. These assets do not have shape but do have values; which again are sometimes indeterminate but often capable of estimation. They need to be under the direct control of the organization and capable of yielding future financial gain to be termed as intangible assets belonging to the company. A strong legal right that can lead to future financial gain is a good example of an intangible asset whose valuation is quite indeterminate but nevertheless provides security and the potential for financial gain to an organisation.

The treatment of intangible assets has always been contentious and open to different interpretations. Even today, while IFRS and US GAAP have moved towards convergence in a number of accounting areas, significant differences still remain in their treatment of intangibles. These differences are specific in the treatment of goodwill and research and development costs, and lead to specific differences in the final preparation of financial statements.

It is the purpose of this assignment to examine the differences and similarities between US GAAP and IFRS for the treatment of Goodwill, Research and Development costs, Brands, Patents and Trademarks. A number of texts have been referred for this assignment, especially International Accounting and Multinational Enterprises 6th edition by Radebaugh, Gray and Black, International Financial Reporting: A

Comparative Approach by Roberts, Weetman and Gordon, the US GAAP and <https://assignbuster.com/comparison-of-ifrs-and-us-gaap-in-relation-to-intangible-assets/>

IFRS websites, a number of specialised publications by PWC and the published accounts of many multinational corporations. Accounting statements and established practices are often subject to individual interpretation and the perusal of a number of texts has enabled the researcher to prepare a holistic and critical assessment of the selected topics. Inputs from all these texts and publications have been used in the preparation of this paper.

2. Goodwill

Goodwill arises as an intangible asset and comprises of the difference between the cost of an acquisition and the fair value of its identifiable assets, liabilities and contingent liabilities. A recent analysis by PricewaterhouseCoopers (PWC) estimates that intangible assets accounted for approximately 75 % of the purchased price of acquired companies in recent years. Increasing attention is now being paid on the management of intangible assets and the IFRS3 has responded to this need by detailing accounting procedures for intangible assets. Goodwill makes up approximately two thirds of the value of intangible assets of US companies and the figure for companies registered in the EU would presumably be similar.

Accounting of Goodwill arises in the case of acquisitions where the purchase price exceeds the net cost of purchased tangible assets, the monetary difference being attributed to goodwill and other intangible assets. IFRS procedures, unlike US GAAP, previously required the amortisation of goodwill over a specific number of years, thus establishing an artificial life for this

asset. This procedure has since been changed and with the IFRS position converging with that of GAAP, goodwill is not considered to be a wasting asset anymore. It however needs to be emphasised that this refers only to goodwill obtained from acquisitions. Internally generated goodwill is not reflected as an asset either under IFRS or under US GAAP.

The IFRS enjoins companies to distinguish between goodwill and other identifiable intangible assets. As such the value of other intangible assets like Research and Development, Patents, Trademarks, Brands and others need to be removed from the goodwill basket to arrive at the residual goodwill value. The treatment of goodwill is different from other intangibles as, subject to periodic assessments for impairment, it is expected to maintain its value indefinitely. While both IFRS and US GAAP require goodwill to be valued, reconciled, detailed by way of factors and reflected in financial statements, they have dissimilar modes for its accounting treatment. In most acquisitions the amount of goodwill is significant because of the considerable difference between the purchase price and cost of net assets of the acquired company. The difference in accounting treatment between IFRS and US GAAP thus causes the results of the financial statements prepared under the two methods to vary considerably and calls for a detailed reconciliation. There is no immediate plan to bring about a convergence between these two modes of treatment, which is a matter of regret.

a) Goodwill under IFRS

Goodwill is not amortised any longer under IFRS procedures and is considered to be an asset with indefinite life. It however has to be subjected

to a stringent impairment test, either annually, or at shorter notice if the need arises, to assess for erosion in value. In the event of impairment, the Profit and Loss Account is charged with the computed impairment amount to ensure the immediate highlighting of poorly performing acquisitions.

Goodwill is thus not seen as a steadily wasting asset but one with indefinite life; and with a value linked to the performance of the unit.

Another significant change in the treatment of goodwill has arisen out of the requirement for treating all business combinations as purchases. This will eliminate the possibility of companies' not recording goodwill by pooling the assets and liabilities of various companies together for preparation of financial statements.

The test for impairment of goodwill under the IFRS is carried out at the level of the Cash Generating Unit or a group of CGUs representing the lowest level at which internal managements monitor goodwill. The IFRS also stipulates that the level for assessing impairment must never be more than a business or a geographical segment.

The test is a one stage process wherein the recoverable amount of the CGU is calculated on the basis of the higher of (a) the fair value less costs to sell or (b) the value in use, and then compared to the carrying amount. In case the assessed value is lesser than the carrying cost, an appropriate charge is made to the profit and loss account. The goodwill appropriated to the CGU is reduced pro rata. The IFRS requires detailed disclosures to be published regarding the annual impairment tests. These include the assumptions made for these tests, and the sensitivity of the results of the impairment tests to

changes in these assumptions. M/s Radebaugh, Gray and Black, in their book *International Accounting and Multinational Enterprises* stress that these disclosures are intended to give shareholders and financial analysts more information about acquisitions, their benefits to the acquiring company and the efficacy and reasonableness of impairment reviews.

Negative goodwill arises when the cost of acquisition is less than the fair value of the identifiable assets, liabilities and contingent liabilities of the company. While its occurrence is rare, negative goodwill can well arise when loss making units are acquired or a distress sale gives a company the opportunity to acquire a bargain. In such cases IFRS procedures stipulate that the acquirer should reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination. The excess of net assets over the cost should be recognized and taken to the profit and loss account.

Goodwill under US GAAP

Goodwill was treated as an asset with indefinite life by US GAAP even when IFRS procedures allowed for its amortisation. The change in IFRS procedures is thus a desirable step towards convergence.

In US GAAP, goodwill is reviewed for impairment at the operating level, which specifically indicates a business segment, or at a lower organisational level. In no case can an impairment assessment be made for a level higher than a business segment. Impairment must be carried out annually or even at shorter intervals, if events indicate that the recoverability of the carrying amount needs to be reassessed. While these requirements are similar to <https://assignbuster.com/comparison-of-ifrs-and-us-gaap-in-relation-to-intangible-assets/>

those stipulated by IFRS, the procedure for assessment of impairment is significantly different and comprises of two steps.

In the first step the fair value is computed and compared with the carrying amount of the concerned unit including goodwill. If the book value is higher than the fair value, no further exercise is suggested and goodwill carried forward at the same value. If however the fair value of the reporting unit is lesser than its carrying amount, goodwill is considered to be impaired and the second step is applied. Goodwill impairment, under US GAAP, is measured by computing the excess of the carrying amount of goodwill over its fair value. The computation for this is fairly simple and constitutes of determining the fair value of goodwill by allocating fair value to the various assets and liabilities of the reporting unit, similar to the procedure used for the determination of goodwill in a business combination. The calculated erosion in goodwill needs to be shown specifically as an impairment charge in the computation of income.

The assessment and treatment of negative goodwill is also somewhat different in US GAAP, even though the basic accounting principles are similar to that followed by IFRS. In this case the excess of fair value over the purchase price is allocated on a pro rata basis to all assets other than current assets, financial assets, assets that have been chosen for sale, prepaid pension investments and deferred taxes. Any negative goodwill remaining after this exercise is recognised as an extraordinary gain.

3. Intangible Assets other than Goodwill

Intangible assets other than goodwill are identifiable non-monetary assets without physical substance. M/s Radebaugh, Gray and Black state that intangible assets need to be identifiable, under the control of the company and capable of providing future economic benefits.

While formulation of appropriate modes of accounting for these assets pose challenges to accounting theory and concepts, their importance in business is significant enough to warrant the application of detailed accounting thought. All the texts consulted have devoted significant attention to the treatment of intangible assets. A July 2006 paper on Accounting Standards regarding Intellectual and other Intangible Assets by Halsey Bullen and Regenia Cafini of the United Nations Department of Economic and Social Affairs is also very explanatory and deals with the subject both in depth and with comprehensiveness.

This section deals with the similarities and dissimilarities under US GAAP and IFRS for specific intangible assets e. g. Research and Development Costs, Brands, Trademarks and Patents. While the growing importance of intangible assets call for their inclusion in financial statements, their intrinsic nature makes it difficult to do so. First, there is little connection between the costs incurred for creation of intangibles and their value. Second, it is also difficult to predict the extent of benefits that intangibles will be able to deliver.

Both the IFRS and US GAAP have certain commonalities in the accounting treatment of intangible assets. In case of acquisitions, managements are enjoined to isolate specific intangible assets and value them separately from goodwill. All these assets have to be identified, valued and indicated

separately in the balance sheet. The list of intangible assets that need to be recognised separately, as a result of IFRS 3 is extensive and includes a host of things like patents, brands, trademarks and computer software. IFRS 3 demands that the identification and valuation of intangible assets should be a rigorous process. Experts however feel that while valuing intangibles is essentially associated with subjectivity, logical mental application and the use of working sheets should be able to satisfy the demands of regulators.

IFRS and US GAAP classify intangible assets, other than goodwill, into assets with limited useful life and assets with indefinite useful life. Assets with finite life are amortised over their useful life. While arbitrary ceilings are not specified on the useful life of those assets, they still need to be tested for impairment every year. An asset is classified as an asset with indefinite useful life if there is no probable limit to the period over which it will benefit the firm. It is however rare for intangible assets other than goodwill to have indefinite useful lives and most intangibles are amortised over their expected useful lives. Assets with indefinite lives have to be subjected to rigorous annual impairment tests. The fact that most intangible assets (other than goodwill) are amortised over their expected useful lives requires the determination of the expected useful life of each of the assets acquired.

The general principles detailed above are common to both IFRS and US GAAP and are useful in determining the broad procedures for accounting and disclosure of intangible assets. As previously elaborated, accounting treatment primarily depends upon the determination of the life of an intangible asset, more specifically whether it has an indefinite or finite measurable life.

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All intangibles are governed by the same sets of disclosure requirements. Accordingly, financial statements should indicate the useful life or amortisation rate, amortisation method, gross carrying amount, accumulated amortisation and impairment losses, reconciliation of the carrying amount at the beginning and the end of the period, and the basis for determining that an intangible has an indefinite life. Apart from these requirements, the differences, detailed below, between US GAAP and IFRS in the treatment of Research and Development costs, Brands, Trade Marks and Patents, also need consideration.

Treatment of Research and Development Costs and Brands

Development costs are however assessed for valuation of long term benefits and, amortised over their determined benefit period. Capitalisation of development costs is allowed only when development efforts result in the creation of an identifiable asset, e. g. software or processes, whose beneficial life and costs can be measured reliably. If however a Research and Development project is purchased, IFRS provides for the treatment of the whole amount as an asset, even though part of the cost reflects research expenses. In the case of further costs being incurred on the project after its purchase, research costs will need to be expensed out while development costs will be eligible for capitalisation, subject to their meeting the required criteria.

US GAAP however stipulates that all Research and Development costs be immediately charged to expenses. Certain development costs pertaining to website and software development are however allowed to be capitalised.

Research and Development assets, if acquired are valued at fair value under the purchase method. However if the assets do not have any alternate use they are immediately charged to expense.

Both PWC and publications opine that US GAAP will most probably move towards the IFRS position on Research and Development as part of the short term convergence exercise.

Brands

The treatment of Brands is similar under both US GAAP and IFRS norms. It has been specifically clarified that the value of brands generated internally should not be reflected in financial statements. In case of brands obtained through purchase or acquisition the value of the brand will have to be computed at cost or fair value and it will need to be determined whether the life of the brand is indefinite or finite.

Brands with indefinite lives will need to be subjected to rigorous impairment tests every year, and treated like goodwill. Brands with finite lives, while subject to yearly impairment tests, will need to be amortised like other intangible assets. It needs to be noted that the mode of assessment of impairment in US GAAP is different from IFRS and this factor will accordingly come into play for assessment of impairment.

Trademarks and Patents

The costs of Patents and Trademarks, when developed and obtained internally comprise, mostly of legal and administrative costs incurred with their filing and registration and are expensed out as regular legal or <https://assignbuster.com/comparison-of-ifrs-and-us-gaap-in-relation-to-intangible-assets/>

administrative costs. The IFRS specifies that no revaluation is possible for Trademarks and Patents in accordance with IAS 38. This is because an active market cannot exist for brands, newspaper mastheads, music and film publishing rights, patents, or trademarks, as each such asset is unique.

In the case of patents and trademarks obtained through acquisition, the treatment is similar to the broad category of intangible assets, for identification, valuation, measurement and recognition for purposes of separate disclosure. Acquired patents and trademarks are measured initially at purchase cost and are amortized on a straight-line basis over their estimated useful lives.

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