

Intangible assets essay

[Business](#), [Company](#)



Abstract

Research is a deliberate planned investigation carried out with the aim of developing and acquiring new technical or scientific knowledge and understanding. On the other hand, development refers to the application of the research findings or other useful knowledge to plan, design new products or improve the firm's final products, devices, process of manufacturing, systems or services, usually before commercial production.

Different firms account for R&D costs a bit differently depending on whether they follow local standards or international standards. The accounting for R&D cost has evolved since 1974 this has been due to views of different accountants on whether the costs should be represented as intangible assets or should be classified as normal costs and written off in profit and loss account of the firm.

Introduction

It is essential to account for research and development costs, this recognized by both the international and UK accounting standards. However, the two standards take different viewpoints in their analysis. The rationale for accounting for research and development costs lies on the fact that a lot of money is spend on the research for development of new products and services. This research enables the development of products and services that will be viable and produce sustainable profits in the future, and thus great income in the future.

Accounting for research and development costs (R&D) takes this costs as an asset instead as an expense. This is because there is a future expected

income flows in the business as a result of incurring costs in research for development of products. According to IASB framework and the principles for preparing and presenting financial statements, the R&D costs meet the requirements to be regarded as an asset. At times it is difficult to predict future income flows. However, the international standards and the UK accounting standards provide necessary tools for establishing future income of a given project.

Business assets are of different forms. This includes tangible and intangible assets. Those which do not have physical form are known as intangible assets, while those with physical form are tangible assets. Tangible assets do have physical characteristic such that they can be touched or seen.

However, the intangible assets do not have these characteristics. They are classified into those which can be purchased and internally generated assets. Accounting for purchased intangible assets is easy task that only considered in a similar manner as of tangible assets. However, internally generated assets are much more complicated and require careful thought in their accounting. The recognition of intangible assets requires that they be subjected to a specific criterion provided by the international and UK accounting standards. Research and development costs fall under this category of assets, and therefore, must be subjected to the same criterion.

Research and development (R&D)

Research is a deliberate planned investigation carried out with the aim of developing and acquiring new technical or scientific knowledge and understanding. E. g. a research may be undertaken by a pharmaceutical firm for developing a new vaccine through acquisitions of new knowledge through

the research. At early stage of the research, the company does not have expectations for future economic gains. On the other hand, development refers to the application of the research findings or other useful knowledge to plan, design new products or improve the firm's final products, devices, process of manufacturing, systems or services, usually before commercial production. An illustration of the development is where a car firm designs, constructs and test a pre-production model before the commercial production.

UK standards on R&D

Recognition

The UK accounting standards permits intangible assets to be accounted using the procedures and rules from FRS 10, intangibles and goodwill.

However, accounting for the research and development costs is governed by SSAP 13; its accounting standards technical. According to the SSAP 13 there is no direct relationship between the costs incurred in carrying out a research and expected future gains for the firm. Thus, capitalizing these costs may not be in accordance with accruals concepts. According to the UK standards, research cost is written off in the profit and loss accounts as been incurred.

On the other hand, a cost incurred in development is written off the profit and loss accounts as having been incurred. However, this is not always the case, the development costs may be carried forward as intangible assets under a certain criterion. There are several conditions for this situation, which includes when the project is clearly defined, the expenditure can be separately identifiable, the project can be termed as commercially viable and

when the project income can be considered to outweigh the costs and is technically feasible. Once the above criterion is met, the cost of development may be capitalized or written off in the profit and loss accounts. Moreover, the accounting policy adopted is used consistently for all the development projects. Thus, if the firm considers capitalizing the costs, this should be used for all the projects.

Capitalized development project

When development costs are taken as asset, the SSAP 13 requires that they be amortized for the entire period in which the firm expects gains. In this regard, the amortization begins at the onset of commercial production or the new products are in the market. It is essential to review all capitalized projects at the end of the accounting period. This ensures recognition criteria are met. In addition, when the conditions are doubtful or not met, then the costs are written off the profit and loss accounts. The SSAP method is deviant with newer international accounting standards giving guidelines for dealing with this area. This creates inconsistencies within companies. For example, the UK standards allow firms to make a choice which is very subjective and as a result firms may manipulate this option by capitalizing all development projects.

International standards on R&D

The intentional accounting standard is different from the UK standards. This is because the UK accounting standards has the SSAP 13 for dealing with the research and developments costs. However, the international standards deal with the research and development costs under the IAS 38. The IAS 38

recognizes intangible assets only when certain criteria are met. Firstly, it requires that there is a high likelihood that future economic gains are likely to flow into the firm. Lastly, if it is possible to estimate the cost of the asset with a high precision. The international accounting standards provide guidelines for recognizing internally generated intangible assets. In this case, the IAS 38 accounts for R&D projects in two phases. These are research and development phase.

In the research phase, the IAS 38 states that all expenses incurred should be written off the income statement and should never be capitalized. This is because at this stage is impossible to predict whether a product or service is able to generate income in the future. While on the development phase, a set criterion is used to evaluate whether intangible assets arising from the development can be capitalized. It must therefore meet the requirements that the asset cost can be precisely determined, there is a technical feasibility for completing the asset, there is a deliberate intention for selling the asset, a market exist for the product or is useful for internal use and there is enough resources for completing the asset. When the above conditions are not met, the expenditures incurred are written off the income statements. However, when all the conditions are met, the costs are capitalized.

Capitalized development costs

After capitalization, the assets are amortized over the finite life with respect to the accruals concept. However, the amortization begins after commercial production. The development projects are reviewed at the end of every

accounting period in order to check whether the recognition criteria hold. Although, where the criteria do not hold, previously capitalized costs are immediately written off the income statement.

A firm may expect future economic gains by incurring expenses in research and development, in this case, the costs incurred should be regarded as an asset. At most times, it is impossible to predict future economic returns from research and development. In this case both the international standards and UK standards enable accountants to more information to clarify this situation.

Development in accounting for research and development costs

Accounting for research and development costs has been problematic in their classification. There have been controversies as whether to classify them as expenses or assets. However, this is purely based on predictions whether the entity shall benefit from the investment in research (Kolodny and Horowitz , 1981). The evaluation of these gains is very subjective depending on the accounting standards applied. Thus, it is possible to classify wrongly the research and development costs. Over the past, accountings for R&D costs have seen some improvement from the past. The developments in accounting for research and development has been made due to the uncertainty of proving that the money spent on research and development will lead to increased future revenue (Bloomer , 1999 and Sougians and lev, 1996).

FAS 2 issued in 1974 required that the following costs of research and development to be written off in profit and loss account: cost of all material

or equipment with no alternative future use, cost of all personnel involved e. g. salaries and wages, any purchased intangible asset with no future use and considerable amount of indirect costs. This is unlike administrative and general costs which should be capitalized if they are closely related to research and development costs. Later, FASB rejected any form of capitalization of research and development expense. The board argued that there is great difficulty in associating R&D to any future revenue. In 1974 there was a drastic change in R&D cost in US i. e. a change from the normal capitalization to expense as recommended by FASB. This made some companies such as OTC firms to reduce their spending on research and development. (Dyckman, Duker and Elliot, 1980)

The board however, considered selective capitalization in light of some specific conditions being met. This method was adopted by firms from UK and many parts of the world. This method required construction or replicating portfolio based on the marketability, technical feasibility and usefulness of the result of the research and development. (Wild and Bailey 2000)

The international accounting standards issued the IAS 9 in 1979 which led to new accounting procedures for accounting for research and development costs (Bloomer, 1999). This was later superseded by the IAS 38, of 1998 this provided accounting guidelines that allow capitalization of R&D costs under certain criteria. The international accounting standards committee (IASC) was constituted to the international accounting standards board in 2001. A professional body, highly supported by governments and industry all round the globe. This came after the financial accounting standards board (FASB)

and was mandated to provide a set of understandable, enforceable and high quality international financial reporting standards. This IFRS would include the IAS and its interpretation as provided by the IASC with inclusions from the IASB. The IASB released a draft copy of proposed amendments to the IAS 38 in December 2002. This later resulted to the IFRS 3 (business combinations (IFRS 3). In 2004 the IASB released the revised IAS 38 and the IFRS 3. Current the revised IAS 38 is used in accounting for the intangible assets that were acquired in business combinations since March 31st 2004. This also applies other intangible assets for the annual period commencing on 31st march 2004. Moreover, the standards provide that both the IFRS and IAS 38 be applied retrospectively.

The IAS 38 recognize cost incurred in research as expenses and no any intangible asset can be recognized at the research phase. Intangible assets at the development phase can only be recognized only when they meet the set criteria. For example, under FAS NO. 86, the criteria for cost capitalization of any computer software for lease, sale or otherwise marketed requires that the software meets the requirements outlined by IAS38 (Alice, Tiessen, and Diewert , 2003). In UK development costs are capitalized and amortized over the defined finite life time of the asset this is in line with accrual concept. Then each project is reviewed at end of accounting period to check whether it still meets the recognition criterion if the project does not meet these criteria it is immediately written off as an expense in profit and loss account. The amortization starts immediately commercial production starts.

Conclusion

All accountants appreciate the need to carry out research in all firms. This is because there is need to bring new products in the market to increase firm's competitiveness and diversify products and services. The problem has always been the best method of accounting for this cost.

Some accountants are for the idea that these costs should be accounted just like the other type of expenses in profit and loss account while others are for the idea of presenting the costs as an intangible asset in balance sheet.

The former argue that there is no clear indication that the expense on R&D will lead to increased future revenues revenue. But the latter argue that R&D cost should be intangible assets because they lead to increased future revenues. This conflicts has led to development on how research and development cost should be accounted.

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