Definition and nature of intangible assets accounting essay

The case study addressed the issues relating to intangible assets. It concentrated on explaining the nature of intangible assets and the valuation and recognition of intangible asset with identifiability and separability concepts. The case described the normative theory of accounting, prescribes how accounting should be practised. Normative theory that is considered in this case study includes current cost accounting and current cash equivalent or exit price accounting. It also discussed about the undisclosed intangibles and the reason behind these high undisclosed intangible values.

The case concentrated on the criteria for recognition and measurement and explained historical cost and market price under mixed measurement system. It discussed about IFRS 3/AASB 3 Standards issued by International Accounting Standard Board, specifies how the cost of business combination is to be determined as well as how the assets and liabilities acquired are to be accounted for and interacts with intangible assets. The nature and calculation of goodwill is also covered in these accounting standards.

Introduction

The case study is about the non monetary assets, characteristics of intangible assets and effect of Business Combination standards on the recognition, valuation and measurement of intangible assets. The purpose of the research is to define the basic elements, nature and characteristics of intangible assets in financial statements and to discuss the criteria for recognising and measuring them. Research has shown the better understanding of IFRS 3/AASB 3 Business Combination standards in the measurement or recognition of intangible assets and valuation of intangible assets in financial statements through normative theories which include current cost and cash equivalent accounting.

All the data related to this case study collected from various academic sources such as books, journals articles and websites which provide the information for the unrecorded and undisclosed intangible assets in balance sheets.

Discussion

1 Definition and nature of Intangible Assets:

In AASB 138, Intangible Assets are defined as non monetary assets lack physical substance. It has some common forms include goodwill, copyrights, patents and trademarks (Deegon, 2007).

There are two key characteristics of intangible assets, namely:

They are identifiable

They are without physical substance

In context of Identifiable or Identifiability:

Identifiable intangible assets: The intangible assets includes patents, trademarks, licences, brand names and copyrights can be considered identifiable because a specific value can be placed on each individual asset, and they can be separately identified and sold.

According to Deegon (2007), In IAS 38, the criterion of identifiability arose out of the Business Combinations project and the concern that, in identifying the assets and liabilities acquired, the intangible assets acquired must be distinguished from goodwill. Goodwill is an unidentifiable asset that AASB 138 does not allow to be recognized. Non physical assets cannot be recognised unless they are identifiable. The reason for this restriction is that it makes the subsequent measurement of assets easier.

An Intangible asset is identifiable if it meets either the separability criterion or the contractual legal criterion. According to Deegon (2007, pp. 270), Paragraph 12 of AASB 138 states that:

An intangible asset is identifiable if it 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; for example:

Market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer should recognise the depositor relationship intangible asset separately from goodwill (Deegon, 2007).

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 (Picker et al., 2009). for example:

An acquire owns and operates a nuclear power plant. The licence to operate that power plant is an intangible asset that meets the contractual legal criterion for recognition separately from goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognise the fair value of the operating licence and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.

List of identifiable intangible assets contained in IASB's IFRS 3 Business Combinations (2008)

Picker (2009, pp. 391) explained the list of assets that could potentially meet the identifiability criteria:

Basis

Marketing-related intangible assets

Trademarks, Trade dress, Newspaper mastheads, Internet domain names, Non-competition agreements

Contractual

Customer related intangible assets

Customer lists and relationships

Non contractual

Order or production backlog, Customer contracts and related relationships

Contractual

Artistic related intangible assets

Plays, operas, ballets, books, magazines, newspapers, other literacy works, musical works, pictures, photographs, video and audiovisual material

Contractual

Contract based intangible assets

Licensing, royalty, stand-still, lease and Franchise agreements, advertising, construction, management, service or supply contracts, construction permits, operating and broadcast rights.

Contractual

Technology based intangible assets

Patented, computer software, mask works and trade secrets

Contractual

unpatented technology and databases, including title plants

Non contractual

Separable or Separability in context of asset recognition:

All the individual assets of a business, whether intangible or not, are separable from each other when it possible to aggregate or disaggregate them without loss or gain in the recognition and measurement of those individual assets such that the sum of them would always be equal to the whole of the assets of the business. Or Separable assets are those that can be transfer to another firm, without having to buy or sell the company as a whole.

Separability in Intangible asset:

In the context of intangible assets, separability signifies identifiability, and intangible assets with that characteristic that are acquired in business combination should be recognised as assets separately from goodwill.

According to Cohen (2005), The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquire and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability.

An intangible asset that the acquirer would be able to sell, license or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license or otherwise exchange it.

An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them. For example:

Customers and subscriber lists are frequently licensed and thus meet the separability criterion. Even if an acquiree believes its customer lists have characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion (Cohen, 2005).

However, a customer list acquired in a business combination would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers (Cohen, 2005).

Criteria of Recognition:

Deegon (2007) found that an intangible asset shall be recognized if

It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity and

The cost of the asset can be measured reliably

Reducing the number of assets recognised in the financial statements because of measurement problems may also reduce the relevance of the information provided in those financial statements. If an intangible asset is acquired as a part of business combination it is to be recognised as its fair value. However, if it is acquired separately it is to be recognised at cost (CPA 2007).

AASB 138 specifically prohibits brand, mastheads, publishing titles, customer lists and assets arising from research, following internally generated intangible assets from being recognised. Internally generated goodwill shall not be recognised as an asset. The recognition is not permitted because it is not an identifiable resource controlled by the entity that can be measured reliably at cost. Goodwill by nature is not separable nor does it arise from contractual or other legal rights (CPA 2007).

AASB 138, all intangible assets must meet the identifiability criterion, one part of which is separability, which is the capability of being separated and sold or transferred (Picker et al., 2009).

2 Intangibles Valuation

AASB (2008), AASB 138 notes that it is uncommon for an active market to exist for intangible assets. Expenditure on an intangible item that was initially recognised as an expense cannot be recognised as part of the cost of an intangible asset at a later date. Intangibles are difficult to trade. Legal property rights are often hazy, contingent contracts are difficult to draw and the cost structure of many intangibles is not conductive to stable pricing. Accordingly, at present there are no active, organized markets in intangibles. Private trades in intangibles do not provide essential information for the measurement and valuation of intangibles (Alfredson et al., 2006).

Non physical assets have the above characteristics they cause the particular problem for accountants. Accountants have two activities related to assets are the recognition and measurement of the assets. With non physical assets, the determination of when they should be recognised and they should be measured is in general more difficult. Non physical assets cannot be recognised unless they are identifiable, it makes the subsequent measurement of assets easier (Alfredson et al., 2007). According to the bar chart on asset spit, undisclosed intangible assets are a major portion of the asset base of modern companies and this will grow as firms move further towards service industries.

IASB (2010), The only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination are when the intangible asset arises from legal or other contractual rights and either:

Is not separable

Is separable, but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables.

Current Cost Accounting Theory:

If we are using CCA than intangibles should always be valued and reported in financial statements irrespective whether they are separable or not.

According to Delaney & Whittington (2010), Current Cost Accounting is a method of valuing and reporting assets, liabilities, expenses and revenues at their current cost at the balance sheet date or at the date of their use or sale. CCA discards historical cost as a reporting model. It introduces current costs rather than historical costs into accounts. Whittington (2004), the general aim of the current cost theory is to provide a calculation of income that, after adjusting for changing prices, could be withdrawn from the entity yet still leave the physical capital of the entity intact. Such measures of income are often promoted as true measures of income. The maintenance of the firm’s physical capital or operating capacity is a central goal of current cost accounting. Proponents of this normative theory argue that by valuing assets at their current costs, a truer measure of profit is provided than in reflected by the historical cost system.

Henderson & Harries (2004, pp. 200-201) stated that Current cost provides a more relevant measure of financial performance than historical cost and more useful for decision makers. The use of CCA enables the separation of holding and operating gains and that is recognises profit as it is earned. Under current cost accounting any inputs are treated as investments and require an economic return. That includes all outlays on intangible assets such as marketing and R & D. Hence, a reasonable expectation is that all costs be capitalised and the income from those investments be evaluated. This would place a greater emphasis on return from these investments.

Exit Price Theory (Current Cash Equivalent):

According to Henderson & Harries (2004, pp. 201-202) Under Current Cash Equivalent Accounting, intangibles are not valued because a number of intangibles are not capable of separation. In this accounting theory intangibles would only be capitalised if they are separable and have a current cash equivalent. The theory relies on assessments of the exit and selling prices of an entity’s assets and liabilities.

Belkaoui & Jones (2010), Key assumptions of this theory’s are:

Firms exist to increase the wealth of the owners.

Successful operations are based on the ability of an organisation to adapt to changing circumstances and

The capacity to adopt will be best reflected by the monetary value is based on the current exit or selling prices of the organisation’s resources (current cash equivalent).

Belkaoui & Jones (2010), in this theory all assets should be recorded at their current cash equivalent (CCE). Current cash equivalent represented by the amounts expected to be generated by the selling of assets. Within the model, the balance sheet should clearly show the expected net selling prices of all the entity’s assets.

Delaney & Whittington (2010), According to theory, if assets cannot be separately sold, for the purposes of determining the organisation’s financial position they are deemed to have no value. Assets such as goodwill or some work in progress would be assessed as having no set selling price and therefore would be attributed zero value. There are many criticisms of this theory that it does not consider the ‘ value in use’ of assets. If an asset is retained, rather than sold, its value in use would likely be greater than its current exit price, Such as a blast furnace that is generating positive returns. It has a positive value in use but if it cannot be sold separately than it has no value. However, if something generates a positive return, it should have a market and corresponding market value (Delaney & Whittington, 2010).

3 Definition of undisclosed values or undisclosed intangible assets:

IPA (2010), Undisclosed value is the difference between enterprise value and net asset value. Here enterprise value means the total value of the business, made up of the market value of both equity and debt funding and net asset value means balance sheet both tangible and intangible assets, less liabilities. Or the difference between the stock market value of equity and disclosed shareholders’ equity.

High undisclosed value sectors:

According to the bar chart ASX 200, Telecoms and Energy sectors having the highest level of undisclosed or unrecorded values. In the bar graph ASX 200 63%, Energy 64% and Telecoms have 68% undisclosed values those are highest than others.

In brand Finance’s experience, internally generated intangible items constitute the bulk of the undisclosed values in most industries (Brand-Finance 2010).

Reasons of high undisclosed intangibles:

The high value of undisclosed intangibles means that the accounting system is still failing woefully to provide fully rounded information on overall company value.

The possible reasons of highest undisclosed value for ASX 200, Telecoms and Energy are (IPA 2010):

Volatile market: The sector Telecoms, Energy and ASX 200 has high undisclosed intangibles due to volatility in the market. They don’t have stability in the market. Tendency of market in these sectors is to rise or fall sharply within a short period of time that’s why ASX 200 (63%), Energy (64%) and Telecoms (68%) have high unrecorded values. One solution is to deal with volatility in market is to maintain a long term horizon and ignore the short term fluctuations.

Difficult to disclose measurement: The other reason for high undisclosed values in these sectors is they did not disclose any measures that would allow observers to better understand the value of their customer base. It’s difficult for investors to know how well a company measures or manages factors that have the potential to create future value.

Measurement is always subjective rather than objective: Measurement in these sectors is less reliable. Subjective measurement in these sectors represents the error in measurement which causes the high undisclosed values.

4 Mixed measurement and Measurement process:

Measurement involves assigning monetary amounts at which elements of the financial statements are to be recognised and reported. Variety of measurement bases are used today to different degrees and in varying combinations in financial statements, including historical cost, current replacement cost, net realisable value and discounted expected future cash flows (IASB 2010).

A mixed measurement model best reflects how businesses operate as it enables the fair value measurement of assets and liabilities managed on a fair value basis. Where the entity does not manage the instruments on a fair value basis, amortised cost represents the most appropriate way to estimate future cash flows.

According to Rutherford (2000, pp. 153), in analysing measurement, the statement focuses on the discussion between two measurement bases, namely historical cost and current price. The statement requires that the measurement basis employed for each category of assets and liabilities should be selected to meet the objective of financial statements. It points out that there are two possible approaches to the specification of measurement basis. A single basis could be specified to apply for all categories of asset and liability or a measurement basis could be specified separately for each category of assets and liabilities, yielding a mixed measurement system. The latter approach will be adopted, combining historical cost and current value (Rutherford, 2000).

Under historical cost an asset or a liability acquired by a transaction is recognised at the transaction cost, which is the fair value of the consideration given or received in exchange for the asset or liability. Under current value an asset or a liability recognised at current value. Hence, where transactions are carried out at fair value their initial recognition will be at the same amount under both historical cost and current value because the transaction cost will equal the fair value of the asset and liability (Rutherford, 2000).

Current practice of mixed measurement basis:

Rutherford (2000) found that the majority of large companies now use in their published financial statements a combination of historical cost and current value. The system is usually referred to in practice as modified historical cost but this can be argued to be somewhat misleading term, since the modification involves using a different measurement basis and the statement prefers to use the term ‘ mixed measurement basis’.

Mixed measurement in IFRS 3/AASB 3 Standards

The accounting standard relevant for accounting for business combinations is AASB 3, issued by the AASB, which is the Australian equivalent of IFRS 3 issued by International Accounting Standard Board (IASB) in 2008.

The IASB Standards today result in what is called a ‘ mixed attribute accounting model’, with different measurement bases for different type of assets, liabilities, income and expenses. Some members of IASB have a tendency to favour fair value measurements if at all possible (reliable). Other members lean towards cost based measures (IASB 2010).

Picker et al. (2009) In accordance with AASB 3, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. However, if it is acquired separately it is to be recognised at ‘ cost’. The fair value reflects market prices about the probability that the future economic benefits embodied in the asset will flow to the entity.

IASB (2010), Para BC126 of the basis for conclusions on IFRS 3 states explicitly that the acquirer is required ‘ to recognise identifiable assets acquired and liabilities assumed regardless of the degree of probability of an inflow or outflow of economic benefits’. The assets acquired and liabilities assumed are measured at fair value. The effects of probability are then built into the measurement of the fair value, and that amount is always expected to be received for assets or paid out for liabilities.

Picker et al. (2009), AASB 3 ‘ Business Combinations’, purchased goodwill is measured as the excess of the cost of acquisition incurred by the acquirer over the fair value of the identifiable net assets and contingent liabilities acquired. Fair value is defined in Appendix A to AASB 3/IFRS 3 as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.

When Australia released its new Accounting Standard AASB 3 ‘ Business Combinations’ as part of the process of adopting IFRSs by 2005, the requirement to systematically amortise goodwill was abandoned, Para 55 of AASB . After adopting IFRSs, where intangible assets are recognised they will record at cost, less accumulated amortisation, rather than being shown at their fair value (Deegon, 2009).

Conclusion

It can be concluded that intangible assets is concerned with the definition, recognition, measurement and disclosure of intangibles. Intangible assets are considered to be sufficiently different from other assets for the standard setters to provide a separate standard. The reason is that the nature of intangibles is such that there are particular measurement problem associated with these assets that require specific accounting principles to be established. The research shown that the characteristic of ‘ identifiability’ is critical to the identification for intangibles and is the same concept that arises in AASB 3/IFRS 3 Business Combinations in relation to identifiable assets and liabilities recognised by the acquirer. Intangible assets acquired within a business combination are easier to recognise than those internally generated by the entity because within a business combination the measurement issues are limited by the amount of the cost of the combination.

The findings indicate that development of normative theory include current cost and current price equivalent or exit price accounting is related to the issues associated with changing prices and their effect on profits and asset valuation. All over it can be concluded that recognition, valuation or measurement are the important parts of intangible assets. Measurement is very important in accounting in that it is the process by which valuations are placed on all elements reported in financial statements. Measurement is the last step in reaching at the accounting numbers that appear in financial statements. An item must first meet the definition of the statement element, the recognition criteria then be satisfied, finally it is measured.