CHAPTER 11
INTANGIBLE ASSETS

Quick test

Question 1

An intangible asset, as any other asset, is a present economic resource controlled by the company as a result of past events. An economic resource is a right that has the potential to produce economic benefits (IASB ED to *Conceptual Framework (2015)* para. 4.4). A company controls an asset if the company has the present ability to direct the use of the economic resource and obtain the economic benefits that flow from it. The ability of a company to obtain the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because a company may be able to control the future economic benefits in some other way.

A company may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The company may also expect that the staff will continue to make their skills available to the company. However, a company usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition of an intangible asset.

In this case, therefore, it is highly unlikely that the company has any intangible assets as defined by IAS 38 *Intangible Assets*. The manager's salary and the training costs would be accounted for as expenses.

Question 2

Brand KidzToys

Even though the brand KidzToys is not recognised in Warmington plc's individual financial statements, on acquisition of the company by Fraser plc, the brand is identifiable and its fair value is established. It is therefore recognised in Fraser's consolidated financial statements.

Its value at 30 June 20X4 is its fair value of £15 million minus one year's amortisation of £3 million, i.e. £12 million.

Goodwill on acquisition

Under IFRS 3 *Business Combinations*, the difference between the purchase price of Warmington and the fair values of its separable net assets is goodwill arising on acquisition. This meets the definition of an asset as it represents future economic benefits arising from assets which have not been identified and recognised separately. It can therefore be recognised in Fraser's consolidated financial statements. Goodwill is not amortised, but it is tested annually for impairment. At 30 June 20X4 it is found not to be impaired.

Goodwill is therefore included at:

	£m
Acquisition price	50
Less: Fair value of net assets at acquisition	
KidzToys brand	(15)
Other net assets	(25)
Goodwill	10

Develop your understanding

Question 3

If a company establishes relationships with its customers through contracts, those customer relationships arise from contractual rights. Therefore, customer contracts and the related customer relationships acquired in a business combination meet the contractual-legal criterion of an intangible asset specified in IAS 38 *Intangible Assets*, even if confidentiality or other contractual terms prohibit the sale or transfer of a contract separately from the acquiree. IFRS 3 *Business Combinations* also lists customer-related contracts as intangible assets which are to be identified separately in an acquisition.

(a) So the contract to be Gamma's exclusive supplier of sporting goods, whether cancellable or not, meets the contractual-legal criterion. Additionally, because Beta establishes its relationship with Gamma through a contract, the customer relationship with Gamma meets the contractual-legal criterion. Because Beta has only one customer relationship with Gamma, the fair value of that relationship incorporates assumptions about Beta's relationship with Gamma relating to both sporting goods and electronics.

However, if Alpha determines that the customer relationships with Gamma for sporting goods and for electronics are separate from each other, Alpha would assess whether the customer relationship for electronics meets the separability criterion for identification as an intangible asset.

(b) Regardless of whether they are cancellable or not, the purchase orders from 60% of Epsilon's customers meet the contractual-legal criterion. Additionally, because Epsilon has established its relationship with 60% of its customers through contracts, not only the purchase orders but also Epsilon's customer relationships meet the contractual-legal criterion. Because Epsilon has a practice of establishing contracts with the remaining 40% of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though Epsilon does not have contracts with those customers at 31 December 20X5.

Question 4

1 January 20X2
This is an external acquisition of an intangible asset, and the asset is accounted for initially at cost. However, since payment is not due for two years from the date of purchase, the cost of the asset is considered to include a financing element, calculated by reference to the entity's borrowing rate.

So the cost is £177,999 (£200,000 / 1.06^2) and a liability to the supplier of the same amount should be recognised.

Year ended 31 December 20X2
In the statement of profit or loss the following should be recognised as expenses:
A depreciation charge of £17,800 (£177,999 / 10)
A finance charge, which is the unwinding of the discount over one year, of £177,999 x 6% = £10,680

In the statement of financial position the following carrying amounts should be recognised:
Intangible assets of £160,199 (£177,999 – 17,800)
A liability to the supplier of £188,679 (£177,999 + 10,680)

Question 5

(a) The broadcasting licence would be treated as having an indefinite useful life because it is expected to contribute to the entity's net cash inflows indefinitely. Therefore, the licence would not be amortised until its useful life is determined to be finite.

The licence would however be tested for impairment in accordance with IAS 36 annually and whenever there is an indication that it may be impaired.

(b) Because the broadcasting licence can no longer be renewed, its useful life is no longer indefinite. Therefore from 1 January 20X3, the acquired licence would be amortised over its remaining three-year useful life and immediately tested for impairment in accordance with IAS 36.

Take it further

Question 6

IAS 38 *Intangible Assets* requires that an intangible asset should be recognised if, and only if, it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably.

In addition, IAS38 requires that 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:

1. The technical feasibility of completing the intangible asset so that it will be available for use or sale.
2. Its intention to complete the intangible asset and use or sell it.
3. Its ability to use or sell the intangible asset.
4. 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.
5. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
6. Its ability to measure reliably the expenditures attributable to the intangible asset during its development.

Otherwise development costs are expensed in the statement of profit or loss. Costs remain written off, so it is only those incurred after all criteria are met that can be capitalised.

In respect of Airpro plc’s project, the company does have a confirmed order from a customer and funding is available from the venture capitalists. So criteria 2, 4 and 5 above can be considered to be satisfied.

The detailed expenditures in respect of Airpro plc’s project are now considered.

<u>January – salaries of technicians and engineers</u>
The salary costs of the research and development team engaged in generating the new product are developmental costs directly attributable to the development of the new product. The salaries of the development team can be recognised as an intangible asset only when all the recognition criteria have been satisfied. However, only those expenditures incurred *after* the date at which all the recognition criteria are met should be recognised as an intangible asset. Expenditure incurred prior to this date cannot be reinstated and should not form part of the cost of the intangible asset. In January not all criteria for the capitalisation of the project have been met, so the salaries of £175,000 will be written off as an expense.

<u>March – development of duct and test model</u>
The development of a test model implies that the project is not yet able to be considered technically feasible, so criterion 1 above is not met. The costs of £250,000 will be written off as an expense.

June – revision of the ducting processes
Although these costs appear to improve the project's technical feasibility, the prototype has not yet been tested. Whether the ducting is able to be used and sold (criterion 3) is in doubt. Hence these costs of £300,000 will also be written off to the statement of profit or loss.

August – prototype
These costs appear to be incurred to ensure that the technical feasibility and the ability to actually sell the product are satisfied (criteria 1 and 3). Given the details of the various expenditures, it appears that Airpro is able to identify the various costs associated with the project, so criterion 6 is satisfied. Development costs incurred subsequent to August can now be capitalised as an intangible asset. However the cost of the prototype is written off as an expense.

October – engineers' conference costs
The costs of attending a conference, even though related to the product, would not be considered directly attributable costs necessary to create, produce, and prepare the product to be capable of operating in the manner intended by management, which are the only costs that can be capitalised as an internally generated intangible asset. The conference costs would appear to be closer to marketing costs. They are therefore written off as an expense.

December – cash flow budget
Any directly attributable costs incurred can be capitalised as an intangible asset.

Question 7

Even though the R&D costs are not recognised as an asset in Gillet Ltd's individual financial statements, on acquisition of the company by Jolyon Pharmaceuticals plc at 31 December 20X6, the project is identifiable and its fair value is established at £800,000. It is therefore recognised in Jolyon Pharmaceuticals' consolidated financial statements initially at its fair value on acquisition. The costs of £500,000 written off to Gillet's profit and loss are irrelevant for consolidated financial statement purposes.

In order to be recognised as an intangible asset, the subsequent expenditure on the project needs to meet the six criteria required for the capitalisation of development expenditure, namely:
(a) the product must be technical feasible so that it will be available for use or sale
(b) the company must have the intention to complete the product and use or sell it
(c) the company must have the ability to use or sell the intangible asset
(d) it is expected that the product will generate probable future economic benefits evidenced by the existence of a market for the product or, if it is to be used internally, the usefulness of the product
(e) adequate technical, financial and other resources to complete the development and to use or sell the product must be available

(f) the company must have the ability to measure reliably the expenditure attributable to the product during its development

From the details provided, it appears that these criteria are not met until 31 March 20X8 when the drug is approved by the regulatory authorities, and Gillet considers that it is also commercially viable. An assumption is made that the other criteria are also met at this point. Expenditure prior to this date is written off to profit and loss in the consolidated financial statements (as they are in Gillet's own financial statements).

Amortisation of the capitalised asset does not commence until the asset is available for use, in other words from 1 November 20X8 when the drug starts being marketed and sold.

	£
Year ended 31 December 20X7	
Statement of financial position	
Intangible asset – development costs (at fair value at acquisition)	800,000
Statement of profit or loss	
Development expenditure	900,000
Year ended 31 December 20X8	
Statement of financial position	
Intangible asset	
Development costs (fair value at acquisition)	800,000
Subsequent expenditure from 1 April 20X8 (7/10 x 1,000,000)	700,000
	1,500,000
Amortisation (2/12 x 1,500,000 / 10)	(25,000)
	1,475,000
Statement of profit or loss	
Development expenditure to 31 March 20X8 (3/10 x 1,000,000)	300,000
Amortisation of intangibles	25,000