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Accounting for Intangibles Assets

ABSTRACT

It becomes the bounden duty for accounting and regulatory institutions worldwide to endow the corporate community with well-formulated accounting structures and procedures to minimize asymmetry in information dissemination of financial statements. The induction of FAS 141 and 142 into the accounting manual is indeed welcome. Despite their shortcomings, the standards constitute a positive measure towards developing a scientific framework for intangible accounting. The none, too few, critical issues that remain unresolved shall gradually be remedied with more research, coupled with the industry feedback on implementation and one may expect that in due course loopholes would be plugged and the shortcomings and ambiguities would be reduced. One could, then, move towards perfecting the nuances of 'intangibles accounting'.

In this paper we highlight some of the issues that are controversial, ambiguous, or need further refinement in so far as intangible accounting is concerned.

INTRODUCTION

Corporate are being compelled to adopt innovative strategies in an effort to sustain margins and thereby, manage subsistence. As fallout, the frequency and quality of corporate merger/s acquisitions/ takeovers have grown manifold and 'business combinations' have become an essential ingredient of the corporate strategy rulebook. As a consequence of the rapid evolution of such complex corporate strategies and practices, the need for rational and streamlined accounting standards/norms, in the context of 'business combinations accounting', to facilitate transparent and symmetrical disposition of all 'relevant' facts without any element of 'window dressing' is immediate and its importance can hardly be overstated.

Commensurate with this exponential and rapid growth in the instances of corporate amalgamations, there needs to be developed a comprehensive framework insofar as the accounting treatment and financial reporting of related issues are concerned. The extant regulatory pronouncements are inconsistent and incomplete, not only across the different types of business combinations but also across different countries and, in some cases, states as well.

As one of the most sensitized professional outfit, the Financial Accounting Standards Board (FASB) of the US enacted FAS 141 and 142 titled 'Business Combinations' and 'Accounting for Goodwill and other Intangible Assets', respectively in June 2001, the provisions of which become applicable to all US-based entities for fiscal years beginning after December 15, 2001.

The induction of FAS 141 and 142 into the accounting manual is indeed welcome. Although several critical issues remain unresolved, the complete vacuum in 'intangible accounting' has largely been addressed. In this article, we examine some of the issues that are cardinal to intangibles accounting, highlighting those that are controversial, ambiguous or need further refinement. We also discuss the extant accounting and reporting requirements in relation to intangibles under the Indian laws and also under the relevant International Accounting Standards, comparing it with the provisions of FAS 142.

HISTORY

Brief History of Process of Development

Year	**Events**
1988	IASC Began work on IAS for Financial Instruments
1995	IAS 32 published by IASC.
March 1997	IASC and CICA jointly published a Discussion paper on Accounting of Financial instruments.
December 1999	IAS 39 was first issued.
August 2001	IASB announced to undertake the project to improve IAS 39 and IAS 32.
June 2002	Exposure draft on improving IAS 32 and IAS 39 published.
December 2003	IAS 32 and IAS 39 revised published.
March 2004	Amendment relating to macro hedging published.
April 2004	Exposure Draft on Fair Value Option
July 2004	Transition and initial Recognition of Financial Assets and Financial Liabilities.
July 2004	Cash Flow Hedge Accounting of Forecast Intragroup Transactions (July 8, 2004)
July 2004	Financial Guarantee Contracts and Credit Insurance (July 8, 2004).
July 2004	International Financial Reporting Standard (IFRS) ED 7 *Financial Instruments: Disclosures* (July 22, 2004)

The first public pronouncement with regard to goodwill accounting came as late as 1970, when the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) issued Opinion No. 16 titled 'Business Combinations' followed almost immediately by Opinion 17 titled 'Intangible

Assets'. Prior to the issue of these public pronouncements, amortization of goodwill was not mandated and it was discretionary on the part of the acquiring entity, whether it desired to retain goodwill (defined as the 'excess of the cost of the acquired company over the sum of amounts assigned to identifiable assets acquired less liabilities assumed', Para 87 of Opinion 16) in its balance sheet. Opinion 17 put in place, for the first time that 'goodwill' shall necessarily be amortized over a maximum life span of 40 years. Studies have, however, shown the inclination of corporate to account for business combinations on a 'pooling of interests' basis that does not entail recording and consequential amortization of purchased goodwill. This practice has the advantage of eliminating any encumbrances on future profits of the entity due to good will amortization.

Opinions 16 and 17 were, largely, not well received by the accounting fraternity. The reasons were many e.g., (a) since the choice of a 'purchase' method vis-à-vis 'pooling of interests' method is, to a large extent, subjective, we could well have a situation where similar state of affairs is accounted for and hence, reported differently; (b) the pronouncements encourage the use of 'pooling of interests' method of merger accounting for the reasons explained above. However, this puts the US accounting requirements on a different platform compared to other global standards with regard to merger accounting.

In the backdrop of these shortcomings, the FASB of the US came up with an Exposure Draft (ED) in September 1999 titled 'Business Combinations & Intangible Assets'. While explicitly acknowledging the fact that no standard pattern of goodwill amortization could relate completely to the consumption pattern and consequential diminution in value of goodwill, the ED clearly demonstrated the wariness of the lawmakers to completely do away with regulatory provisions for (non) amortizing goodwill. The message in the ED was apparent that goodwill monitors and regulatory provisions relating to (none) amortization arid reporting, thereof, were there to stay in the rulebook. The concept of an annual 'impairment test' for intangibles was mooted for the first time as a two step process with the first step not involving any discounting of projected earnings/cash flows. It was also envisaged in the ED that finite-lived intangibles shall necessarily be amortized over a period not exceeding their respective useful lifespan. In India it is issued by ICAI in the year (1/4/2002).

Before we take up a critical analysis of the extant status insofar as 'intangibles accounting' is concerned with particular reference to FAS 141/142, it would be appropriate to summarize herein the key provisions of the two standards in a few paragraphs to facilitate continuity.

As mentioned above, APB Opinion 16 relating to business combinations had left it discretionary on the corporate entities to choose between the 'pooling of interests' method or the 'purchase' method for accounting for mergers and acquisitions.

Although a large majority adopted the former in an attempt to ensure that subsequent earnings do not suffer the 'drag' effect due to goodwill amortization, the practice was not universal with the consequence that economically, similar looking business combinations could produce strikingly different financial statements due entirely to the adoption of different accounting methods.

Towards rectifying this serious anomaly, FAS 141 was pronounced in June 2001 superseding APB Opinion 16 and making it mandatory for all business combinations (excluding certain explicitly specified ones) to be accounted for, via the ‘purchase’ method. Disclosure of the primary reasons for such ‘business combinations’ and details of the amounts allocated towards the assets acquired, both tangible and intangible (including goodwill) is also mandated by FAS 141.

In conjunction with FAS 141, FAS 142 has brought about several radical changes insofar as the accounting for acquired goodwill and other intangibles is concerned in suppression of APB Opinion 17. The cardinal shortcoming of Opinion 17 (that considered ‘goodwill’ as a wasting asset and consequentially decreed its amortization over an arbitrary period, to be determined by the reporting entity, but not exceeding 40 years) is addressed in FAS 142. FAS 142 contemplate for the first time, the possibility of ‘goodwill’ having an indefinite life and, as a corollary thereto, mandates amortization only in cases, where such goodwill is believed to possess a finite life span. However, even in such cases, the ceiling of 40 years has been done away with.

Lieu of such mandatory amortization, FAS 142 envisages an annual ‘impairment’ test. In nutshell, the cardinal provisions of FAS 142 are:

- **Annual testing for goodwill and other assets impairment:** All intangible assets (including goodwill) shall be tested for impairment at least once every year. Such impairment testing shall be a two-step procedure. The first step involves the ascertainment of the fair value of the reporting units and their subsequent comparison with the carrying amount of goodwill to identify potential existence of impairment. The second step is concerned with the measurement of such impairment, if impairment is indicated in the first step;
- **Amortization of intangible asset impairment:** In the event of the carrying amount of goodwill (or other intangibles) exceeding its fair value, such impairment losses must necessarily be recognized forthwith as a charge against net income for the relevant year. However, such impairment losses, once debited, cannot be reversed in any subsequent year;
- **Disclosure Requirements:** FAS 142 introduces significantly improved disclosure norms relating to any changes in the carrying amount of intangible assets. Projections of the amortization amounts for the next five years also need to be disclosed in the annual accounts.

Full text of APB Opinions 16 & 17 and FAS 141 & 142 can be accessed from the website of the FASB of the US www.fasb.org

AN EVALUATION

At the very outset, before commenting on the efficacy, or otherwise, of any accounting provisions relating to goodwill or such other intangibles, the two following features that are unique to this class of assets need to be emphasized to put the issues in a proper perspective:

- The very process of goodwill measurement/ascertainment is beset with a plethora of practical 'guesstimates' that make such measurements so subjective as to question the very rational ascribing a value to such assets. On this issue, while there is no doubt that life of accountants an practitioners would be much simpler without having to deal with such 'abstract' assets, the existence of statistical evidence of the 'representational faithfulness' of earnings to the intangible asset content of an asset base (that includes such intangibles) makes such an escape route plagued with the aversion of defying the commandment of 'true & fair' portrayal of accounting figures;
- Closely linked with the absence of a foolproof valuation mechanism for valuing goodwill is the fact that, goodwill recordings/amortizations constitute useful financial information for the investor community, only if such transactions create or modify market perceptions about the 'intangible dimensions' of firm value. In a study of US firms, Jennings, LeClere and Thompson (2001),' the information value (or rather the lack of it) of goodwill amortizations was concluded. It was inferred that earnings before goodwill amortization explained cross-sectional variations in stock prices more comprehensively, than earnings after such amortizations. Paradoxical as it may seem, the authors believed that such amortizations constituted an additional source of 'noise' in earrings measurement.

As corroboration of the 'noise' interpretation of such write offs, it is pertinent to note that the information content, thereof, is not only insignificant but also 'ambiguous'. For instance, such write off s may represent divestment of unprofitable operations with a redefinition of the company's 'core competencies 'such write offs may signal diminution in asset values as a presage of further catastrophes.[2]

IMPLEMENTATIONS:

As per the conventional accounting theory, such expenditure (being in the nature expenses incurred for the maintenance and not the creation of an asset) should be expensed. This would necessarily be the case for companies that have not been involved in any acquisitions and hence, have no component of 'acquired goodwill' whereas companies, as mentioned above, that have component of 'acquired goodwill' i.e., have made business acquisitions that can capitalize such expenses. FAS 141/142, by introducing the concept of non-amortization of goodwill facilitate capitalization of internally generated goodwill uniformly. However, while FAS 141/142 have addressed the issue of a uniform accounting status for acquired and internally generated goodwill, they have still left a vacuum insofar as the treatment of other intangibles is concerned, e.g., all R & D expenses must still necessarily be expensed. Fallout of this is that the financial statements of companies that have substantial internally generated intangibles arising out of significant R & D activity cannot be placed on the same platform as those that have been involved in mergers and acquisitions and so can capitalize such expense.

The above conceptual lacuna is not the only one that visits FAS 141/142. There remain several computational hazards that need to be addressed. Implementation of these standards entails ascertainment of the following:

- The appropriate 'reporting unit';
- The 'lifespan' of goodwill, i.e., whether it has a finite or indefinite life;
- The 'fair value' of the reporting unit.

While acknowledging that 'accounting theory' is, certainly, not an exact science, precise determination of the italicized terms defies all human endeavor. The situation is aggravated further by the absence of appropriate guidelines on the identification of 'reporting units'. The consequence is that corporate covered by these standards may identify 'reporting units' on the basis of differing criteria, again creating impediments to inter firm comparison. Not only this, such variations would manifest themselves as disparities in the quantum of goodwill allocated to such reporting units and the consequential outcomes of the impairment test. Similarly, accurate determination of the useful life of 'goodwill' is impossible. Protagonists of FAS 141/142 may argue that such 'useful life' figures also form the backbone of the entire theory of 'depreciation accounting'. However, one needs to realize that assessment of 'useful life' of a tangible asset is a radically simpler proposition—one has access to variety of technical and historical data to base his estimates on, in the case of tangibles, e.g., plant, equipment, buildings and civil structures. The concept of 'fair value' is not new to the accounting literature. The FASB of the US has been consistently making efforts to introduce a comprehensive 'fair value accounting' formulation that would cover all aspects of accounting—the only factor that has restrained implementation of such a code is, as has been emphasized again and again, the absence of a foolproof valuation mechanism for a precise determination of 'fair value', This issue continues to haunt the accounting professionals worldwide.

For instance, the conventional approach to fair value estimation is usually done by discounting all future cash flows emanating from the asset by using an appropriate discount rate. The two cardinal inputs that go into the computation process, viz., the projected cash flows as well as the discount rate are both extremely subjective, lack precision of measurement and hence are fallible.

TABLE: MANDATED BY FAS 142 AND IAS 38

Attribute	**FAS 142**	**IAS 38**
Definition	Intangible assets are non-current assets (not including financial instruments) that lack physical	Intangible assets are identifiable non- monetary assets without physical substance that are held

	substance.	by an enterprise for use in the production or supply of goods, for rental to others or for administrative purposes.
Recognition of intangible assets	The statement provides for the recognition of identifiable intangible assets that can be measured reliably, separately from goodwill, Such recognition shall be entered in the books of account at cost.	The statement stipulates the following conditions for the recognition of an intangible asset: (a) future benefits that are attributable to the asset will flow to the enterprise (b) the Cost of the asset can be measured reliably.
Amount at which to be recorded in the books	(A) Historical cost, if the asset is acquired in isolation (b) fair value, if the asset is acquired as a constituent of a group.	IAS 38 provide two alternatives to ascertain the amount at which an intangible asset is to be recorded. The preferred option is to carry the asset at the historical cost, less any amortization or impairment loss. However, an option of revaluing the intangible asset and thereafter carry it at the revalued amount (that should reflect the fair value on the date of revaluation), less subsequent amortizations/ impairment losses is also accepted.
Amortization	Intangibles should be amortized over the useful life; the pattern of such amortization should correlate to the consumption pattern of the intangible asset and, in the absence of a discernible pattern, should be amortized on a straight line basis. However, FAS 142 explicitly recognizes that there may exist intangible assets that have an indefinite life. Such assets need to be subjected to an annual impairment review, whence any diminution in the value thereof relative to its fair value be expensed forthwith.	Intangibles should be amortized over their best estimate useful life that shall not, under normal circumstances, exceed 20 years. IAS 28 also provides for impairment testing to ascertain the possibility of the carrying amount of the asset exceeding its recoverable value.
Disclosure requirements	Goodwill relating to the various reporting units of an enterprise should be aggregated and disclosed in the balance sheet. Similarly, all other intangibles should be aggregated and	The following are the disclosure requirements under IAS 38: (a) Each class of intangible asset, stating whether such asset is acquired or internally generated, (b) Details of the amortizations

	disclosed. Details of individual intangible assets, the amounts of amortizations in respect of each such asset, and other changes in the carrying amounts thereof need to be disclosed by way of footnotes.	during the year, stating specifically the useful life, method of amortization, gross carrying amount and the accumulated amortization, A reconciliation statement of all these figures shall also be provided, (c) Any impairment losses recognized in the year shall also be detailed out including, in particular, the assets in respect of which such impairment has been observed.
Provisions relating to impairment testing	According to FAS No. 121/APB Opinion 18	According to IAS No. 36
Provisions regarding capitalization of internally generated intangibles	Capitalization of costs incurred in relation to internal generation of intangibles must necessarily be expensed except when: (a) such costs can be reliably identified; (bi such costs have a determinate life; and (c) such costs are not intrinsic to a continuing operation. Provisions of impairment testing shall apply to the capitalized costs.	IAS 38 segregates the process of internal generation of intangibles into two distinct phases' viz. (a) the research phase, and (b) the development phase. Costs relating to the research phase of the project must be expensed, whereas those pertaining to the development phase can be capitalized. Provisions of impairment testing shall apply to the capitalized costs.
'Fair Value' defined	The fair value of a reporting unit refers to the amount at which the unit as a whole could be brought or sold in a current transaction between willing parties.	The amount obtainable from the sale of an asset in a bargained transaction between knowledgeable willing parties in an active market. In the absence of an active market, the asset should be valued at the price that would be paid as consideration for an arm's length transaction involving the asset.
'Useful Life' defined	The useful life of an intangible asset shall reflect the period over which it will contribute to the cash flows of the reporting entity, not the period of time that would take to develop an intangible asset that would provide similar benefits.	The useful life of an intangible asset is finite or indefinite. The useful life is deemed indefinite, if there is no foreseeable limit to the period over which the asset is expected to generate net cash flows for the entity.
'Goodwill' defined	FAS 141/142 interpret 'goodwill' in terms of the following: (a) the excess of the cost of an acquired entity over the net of the amount assigned to identifiable assets acquired and liabilities assumed, (b) the ability of an enterprise (or	'Goodwill' is defined as a residual payment that the acquirer makes in anticipation of future, synergetic, economic benefits that may arise from the acquired assets or as a consequence of the pooling of assets of the acquirer.

	a group of assets e.g., a reporting unit) to earn a higher rate of return on the set of assets compared to the return that would be earned, if those assets were used individually, (c) the fair value of the expected synergies arising as a result of amalgamating the assets or businesses of the transferor and transferee units.	
Treatment of negative goodwill	The treatment of negative goodwill, i.e., the amount of the excess of the fair value of assets less liabilities, assumed over the purchase price in a business combination differs significantly across FAS 141/142 & IAS 38. As per FAS 141/142, such amount is first adjusted against all acquired assets, except for those specifically excepted. If acquired assets are reduced to zero, any remaining excess is reported as extraordinary gain.	Such excess is reported as 'negative goodwill' without adjusting against the acquired assets and is reported as current or future income as may be the case. Credit outstanding is reported as a deduction from assets.

ACCOUNTING STANDARD 26 FROM INDIAN SCENARIO

Accounting Standard (AS) 26, 'Intangible Assets', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is andatory in nature from that date for the following:

Enterprises whose equity or debt securities are listed on a recognized stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognized stock exchange in India as evidenced by the board of directors' resolution in this regard. All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. Earlier application of the Accounting Standard is encouraged.

In respect of intangible items appearing in the balance sheet as on the aforesaid date, i.e., 1-4-2003 or 1-4-2004, as the case may be, the Standard has limited application as stated in paragraph 99. From the date of this Standard becoming mandatory for the concerned enterprises, the following stand withdrawn:

Accounting Standard (AS) 8, Accounting for Research and Development;

Accounting Standard (AS) 6, Depreciation Accounting, with respect to the amortization (depreciation) of intangible assets; and Accounting Standard (AS) 10, Accounting for Fixed Assets - paragraphs 16.3 to 16.7, 37 and 38.

The following is the text of the Accounting Standard.

Development Phase

An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the following:

the technical feasibility of completing the intangible asset so that it will be available for use or sale; its intention to complete the intangible asset and use or sell it; ability to use or sell the intangible asset; its how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate 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; the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and its ability to measure the expenditure attributable to the intangible asset during its development reliably

CONCLUSION

We are living in a time when a new economic paradigm, characterized by fast innovation, short cycle times, and quality and customer satisfaction is highlighting the importance of intangible assets such as brand recognition. Knowledge innovation and particularly human activity.

'Accounting for intangibles' has always been conscientious issue for accounting bodies across the globe regulatory provisions in this regard have been raw and far between. However, with the advancement in corporate governance Purchase, Qtandrised Norms, relating to accounting and reporting of complex financial positions, including intangibles like, Goodwill, trademark, patents etc. are mandated to minimize asymmetries in the desposition of financial information by corporate. (of which there have been many in last two decades)

Here attempt is made to discuss issues, dimensions, comparisons of intangibles.

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Dr. Prashant Joshi
M.B.Patel Rashtrabhasha Arts & Commerce College,
Ahmedabad