ACCURATE AND RELIABLE

INSIGHT PAPER · IAS 38

Intangible Assets

Why financial statements may no longer reflect the underpinning drivers of value — and what IAS 38 does and does not allow you to capitalise.

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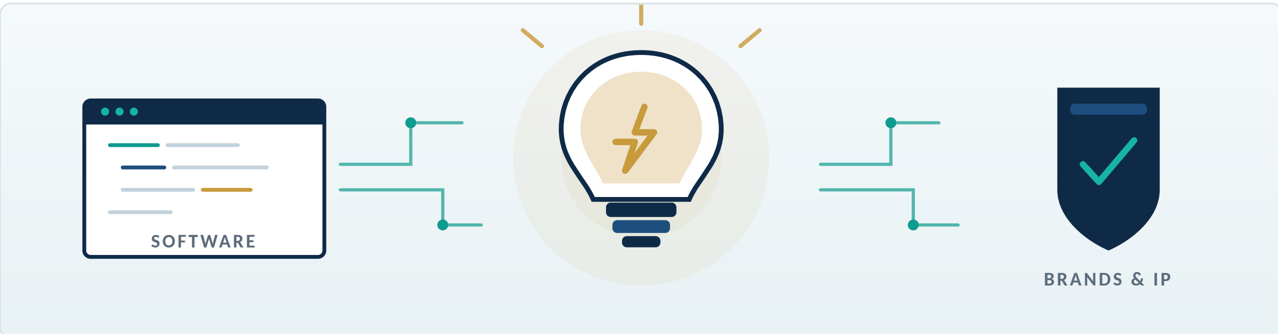
01 — THE GAP

Where value sits, and where it is reported

There are concerns that financial statements no longer reflect the underpinning drivers of value in modern business.

Such concerns are particularly relevant to accounting for internally generated intangible assets and intangibles in general. International Accounting Standard (IAS) 38 *Intangible Assets*, which governs the treatment of the capitalisation of development costs, has been characterised as a standard reflecting **prudence and conservatism** with a corresponding prevalence of expensing. Nonetheless, there is significant lack of evidence about the extent to which companies capitalise other internally generated intangible assets, especially those that fall outside the scope of IAS 38.



Software, brands and intellectual property increasingly drive enterprise value — while the recognition criteria that govern them were built for caution.

02 — THE TEST

The IAS 38 recognition test

According to IAS 38, expenditure for an intangible item is recognised as an expense, unless the item meets the definition of an intangible asset, and:

A

Probable future economic benefits

It is probable that there will be future economic benefits from the asset.

B

Reliably measurable cost

The cost of the asset can be reliably measured.

The cost of generating an intangible asset internally is often difficult to distinguish from the cost of maintaining or enhancing the entity's operations or goodwill. For this reason, **internally generated brands, mastheads, publishing titles, customer lists and similar items are not recognised as intangible assets**. The costs of generating other internally generated intangible assets are classified into whether they arise in a research phase or a development phase.

03 — TWO PHASES

Research and development

RESEARCH PHASE

Expensed

Research expenditure is recognised as an expense in the period in which it is incurred. No asset arises, however promising the work.

DEVELOPMENT PHASE

Capitalised if criteria met

Development expenditure that meets specified criteria is recognised as the cost of an intangible asset. All other development costs are expensed.

Measurement after recognition

Intangible assets are measured initially at cost. After initial recognition, an entity usually measures an intangible asset at **cost less accumulated amortisation**. It may choose to measure the asset at fair value in rare cases when fair value can be determined by reference to an active market.

An intangible asset with a **finite useful life** is amortised and is subject to impairment testing. An intangible asset with an **indefinite useful life** is not amortised, but is tested annually for impairment. When an intangible asset is disposed of, the gain or loss on disposal is included in profit or loss.

04 — SOFTWARE

Software development costs

Under an IFRS reporting regime, accounting for software development costs and the associated capitalisation of relevant expenditure is governed primarily by **IAS 38 Intangible Assets** and less so by **IFRS 3 Business Combinations**. IAS 38 prescribes that an intangible asset shall be recognised if, and only 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.

> **Separately acquired intangibles**
>
> The probability recognition criterion is **always considered to be satisfied** for separately acquired intangible assets, and the cost of a separately acquired intangible asset can usually be measured reliably.

IAS 38 further covers the accounting for internally generated intangible assets, including R&D costs, of which software development costs form a constituent element. **All research costs are expensed.** Development costs must be capitalised on meeting the six conditions specified in IAS 38; all other costs are expensed. The six conditions can be applied to cover those costs incurred in relation to the internal development and use of software or its development for sale, as set out overleaf.

05 — THE CRITERIA

The six conditions

"An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:"

1 **Technical feasibility**
The technical feasibility of completing the intangible asset so that it will be available for use or sale.

2 **Intention to complete**
Its intention to complete the intangible asset and use or sell it.

3 **Ability to use or sell**
Its ability to use or sell the intangible asset.

4 **Probable future economic benefits**
How the intangible asset will generate probable future economic benefits. Among other things, the entity can 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.

5 **Adequate resources**
The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

6 **Reliable measurement of expenditure**
Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

All six must be demonstrable. Failing any one of them means the expenditure is recognised as an expense in the period in which it is incurred, not carried forward as an asset.

The dividing line between research and development decides whether spend becomes an asset or a cost.

When software is part of the hardware

Within IAS 38, specific guidance is also provided in relation to software (including that developed internally) that is **integral to the use of property, plant and equipment**.

INTEGRAL TO THE HARDWARE

Property, plant and equipment

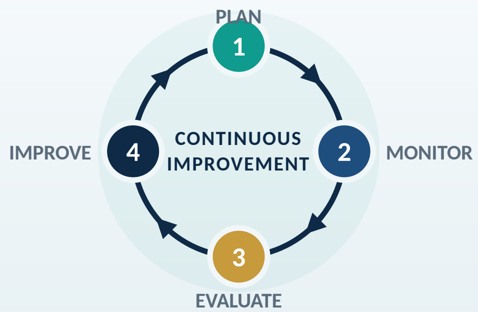
Computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment. The same applies to the operating system of a computer.

NOT INTEGRAL TO THE HARDWARE

Intangible asset

When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

IAS 38, para 4



Recognition is not a one-off judgement — the criteria are reassessed as a project moves from research through development into use.

Capitalising development spend?

To learn more and to know how internally generated intangible assets are recognised, please contact us.

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