Accounting for Intangible Assets

Outline:

1. Definition of Intangible Assets
2. Types of Intangible Assets
3. Characteristics of Intangible Assets
4. Valuation of Intangible Assets
5. Amortization of Intangible Assets
6. Impartment of intangible assets

Definition and common types of intangible assets

1. intangible assets are defined as identifiable non-monetary assets that cannot be seen, touched, or physically measured, and are created through time and effort, and are identifiable as a separate asset.
2. intangible asset is a non-physical asset having a useful life greater than one year. These assets are generally recognized as part of an acquisition, where the acquirer is allowed to assign some portion of the purchase price to acquired intangible assets.

Tangible assets is:

a. with future economic benefits,

b. no physical substance,

c. with high degree of uncertainty concerning the future benefit.

Examples of intangible assets are:

1. trademarks,
2. customer lists,
3. motion pictures,
4. franchise agreements,
5. computer software.
6. Copyrights
7. Patents
8. Goodwill
9. Licenses

Intangible Assets Are:

1. **Artistic assets**: This can include photos, videos, paintings, movies, and audio recordings.
2. **Defensive assets**: You may acquire an intangible asset so that others may not use it. Its useful life is the period over which it is of value in being withheld from the competition.
3. **Leasehold improvements**: These are improvements to a lease holding, where the landlord takes ownership of the improvements. You amortize these improvements over the shorter of their useful lives or the lease term.
4. **Software developed for internal use:** This is the cost of software developed for internal use, with no plan to market it externally. You amortize these costs over the useful life of the asset.
5. **Internally developed and not specifically identifiable**. If there is not a specifically identifiable intangible asset, then you should charge its cost to expense in the period incurred.
6. **Goodwill:** When an entity acquires another entity, goodwill is the difference between the purchase price and the amount of the price not assigned to assets and liabilities acquired in the acquisition that are specifically identified. Goodwill does not independently generate cash flows.

Recognition and measurement of intangible asset:

The recognition of intangible asset requires an entity to demonstrate that the item meets:

1. the definition of an intangible asset and
2. the recognition criteria

An intangible asset shall be recognized if, and only if:

1. it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
2. the cost of the asset can be measured reliably.

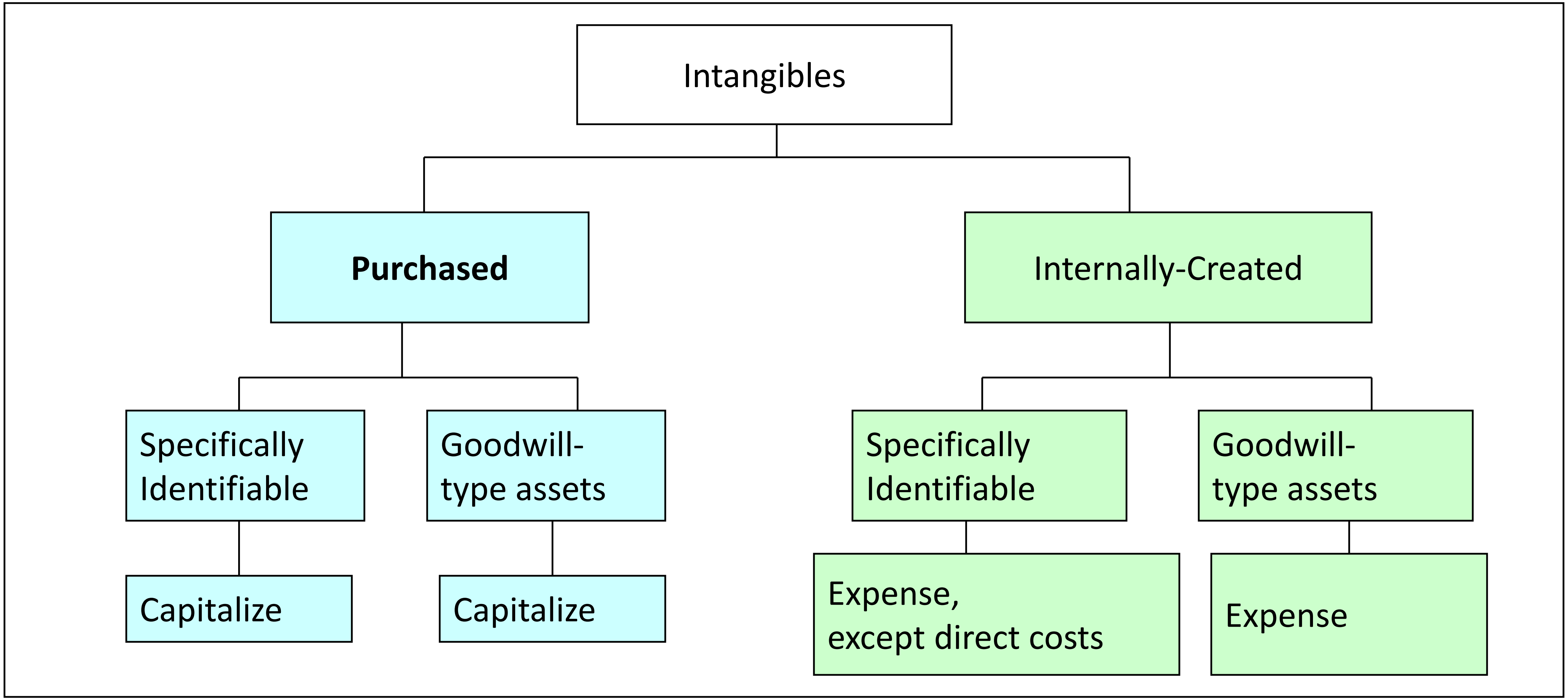
Valuation of Intangible Assets

Not all intangible assets are recognized on the financial statements of a company.

1. The costs to acquire and defend intangible assets are used by accountants to establish intangible asset values.
2. Valuation is an estimate that is subject to change based on market conditions and advances in technology.

Valuation : An estimation of something's worth

Valuation of Intangible Assets



Initial Recognition of Intangible Assets

A business should initially recognize acquired intangibles at their fair values.

You should initially recognize the cost of software developed internally and leasehold improvements at their cost.

The cost of all other intangible assets developed internally should be charged to expense in the period incurred.

An intangible asset shall be measured initially at cost.(IAS,38:24)

Amortization of Intangible Assets

If an intangible asset has a finite useful life, should amortize it over that useful life. The amount to be amortized is its recorded cost, less any residual value. However, intangible assets are usually not considered to have any residual value, so the full amount of the asset is usually amortized.

If there is any pattern of economic benefits to be gained from the intangible asset, then you should adopt an amortization method that approximates that pattern. If not, the customary approach is to amortize it using the **Straight Line method**

So:

- Intangibles are written off over their useful lives, where the assets have *determinable* useful lives.
- Where the intangibles have *indefinite* useful lives, they are not amortized.
- Acquired intangibles should not be written off at acquisition.

1. **Marketing Related Intangibles**:

   A. **Trademarks:** A word, symbol, or phrase used to identify a particular company's product and to differentiate it from other companies' products.
   Trade Names: Trademarks and Trade names are *renewable indefinitely* by the original user in periods of 10 years each.

   Costs of *acquired* trademarks or trade names are capitalized If trademarks or trade names are *developed* by the business, all direct costs (*except R&D costs*) are capitalized

2. **Customer Related Intangibles: Examples include:**

   A. **customer lists**

   B. **order or production backlogs**

   C. **customer relationships**

   Amortize over useful life.

3. **Artistic - Related Intangibles:**

   A. Copyrights: Copyrights are granted for life of the creator plus 50 years, Copyrights can be sold or assigned, but *cannot be renewed,* Copyrights are amortized over their useful life (not to exceed 40 years)

      - Costs of acquiring copyrights are capitalized
      - Research and development costs involved are expensed as incurred

4. Contracted Related Intangibles:

A. Franchises and Licenses: A franchise is a *contractual agreement* under which:

The franchisor grants the franchisee:

- the right to sell certain products or services,
- the right to use certain trademarks or trade names, or
- the right to perform certain functions, within a certain geographical area

- A franchise may be for a *limited time*, for an *indefinite* time period, or perpetual.
- The cost of a franchise (for a limited time) is amortized over the franchise term.
- A franchise (for an unlimited time) is carried at cost and not amortized.
- Annual payments for a franchise are expensed

5. Technology Related Intangibles:

A. Patents(Product Patents and Process Patents): A patent gives an exclusive right to the holder for 20 years.
   1. Costs of purchasing patents are capitalized.
   2. Costs to research and develop patents are expensed as incurred.
   3. Patents are amortized over the shorter of the legal life (20 years) or their useful lives.
   4. Legal fees incurred to successfully defend patents are capitalized.

6. Goodwill

- Goodwill is the most intangible of all assets
- Goodwill can be sold only with the business

Goodwill is the excess of:

1. the cost (purchase price) over
2. the amounts (price) assigned to tangible and intangible net assets

- Goodwill has an indefinite life and should not be amortized.

Acquired Goodwill: Valuation

Example:

Purchase price (cash):$ 100,000,Book value of assets:$88,000,Liabilities:$ 20,000 Market value of assets:$ 102,000, Determine goodwill, if any

Goodwill = Purchase Price - Fair value of net assets

=$100,000 - $82,000

=$18,000

Entry in the books of the Purchaser:

Assets	**$102,000**	
Goodwill	**$ 18,000**	
Liabilities		**$ 20,000**
Cash		**$100,000**

Goodwill Write-off

Acquired goodwill has an indefinite life and should not be amortized.

- Impairment test performed at least annually.
- If applicable, loss recorded.

Negative Goodwill

- Fair value of assets acquired higher than purchase price of assets.
- Resulting credit is negative goodwill (bad will).
- FASB requires that any remaining excess be recognized as an extraordinary gain

Examples:

	Book Value	Fair Market Value
Current Assets	100,000	80,000
Land	100,000	70,000
Buildings	50,000	10,000
TOTAL	250,000	160,000
Liabilities	-50,000	-50,000
Net Assets	200,000	110,000

	Case 1	Case 2	Case 3
Fair market value/ net asset	110,000	110,000	110,000
Net Assets/ net assets	200,000	200,000	200,000
Price	110,000	150,000	86,000
Goodwill	-0-	40,000	(24,000)

Intangible Asset Impairment

If an intangible asset is subsequently impaired, you will likely have to adjust the amortization level to take into account the reduced carrying amount of the asset, and possibly a reduced useful life. An impairment occurs when:

1. the carrying amount of an asset is not recoverable, and
2. a write-off of the impaired amount is needed
3. To determine the amount of impairment, a recoverability test is used

#.The new carrying amount of the intangible asset is its former carrying amount, less the impairment loss. This means that you should alter the amortization of that asset to factor in its now-reduced carrying amount. It may also be necessary to adjust the remaining useful life of the asset, based on the information obtained during the testing process.

Impairment Tests

Type of Asset	Impairment Tests
Property, Plant & Equipment	Recoverability test, then fair value test
Limited Live Intangible	Recoverability test, then fair value test
Indefinite-life intangible, other than goodwill	Fair value test
Goodwill	Fair value test on reporting unit, then fair value test on implied goodwill

Impairments: *The Recoverability Test*

Impairment?

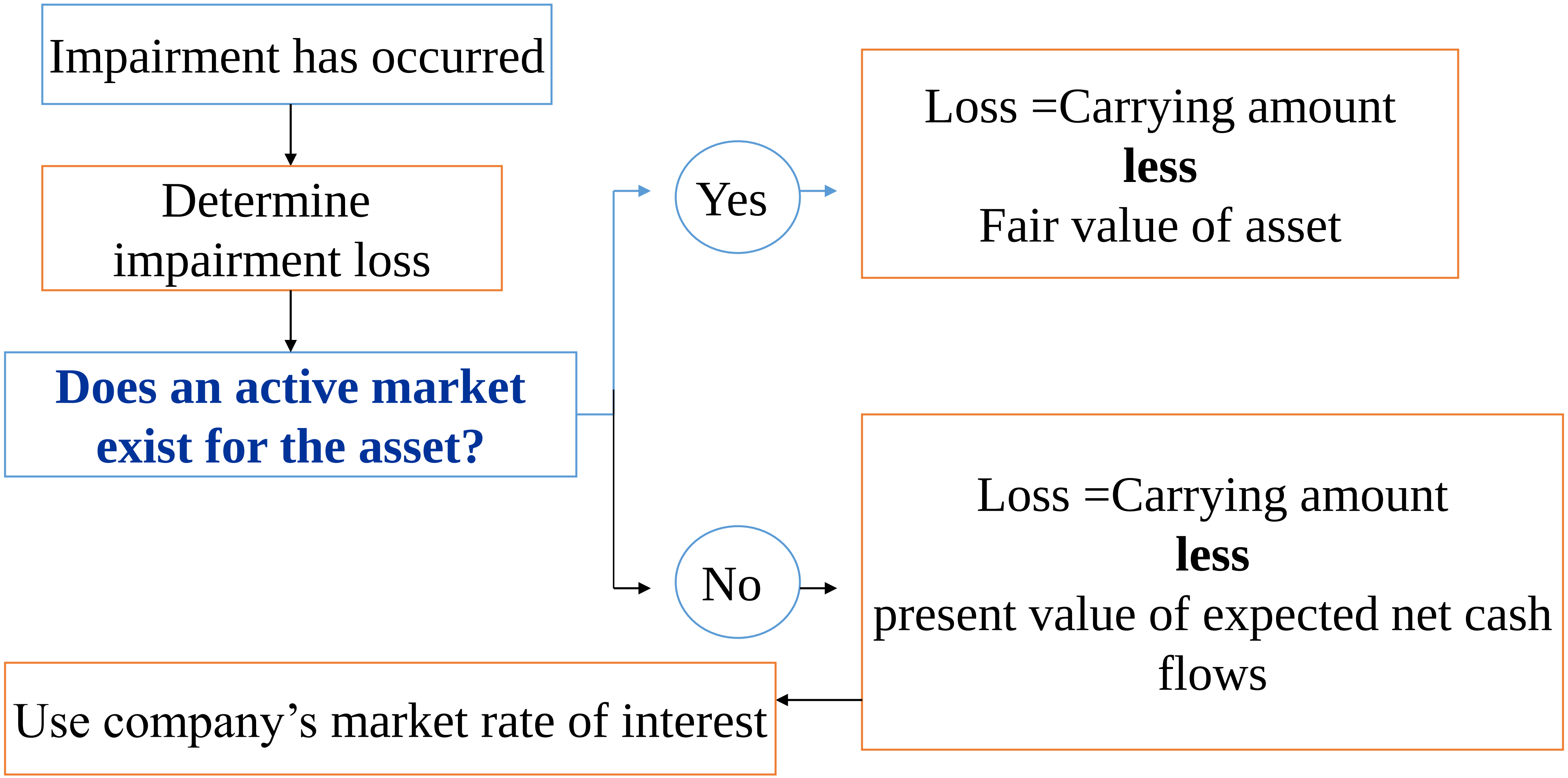
Sum of expected future net cash flows from use and disposal of asset is ***less than*** the carrying amount

Impairment has occurred

Sum of expected future net cash flows from use and disposal of asset is ***equal to or more than*** the carrying amount

No impairment

Impairments: *The Recoverability Test*



Impairment: Accounting

Impairment has occurred

Assets are held for use

1. Loss = Carrying value- Fair value
2. Depreciate new cost basis
3. Restoration of impairment loss is **NOT** permitted

Assets are held for sale

1. Loss = Carrying value - Fair Value- cost of disposal
2. No depreciation is taken
3. Restoration of impairment loss **is** permitted

Impairment Test:

1. Fair Value Test

- Compares fair value of intangible asset with assets' carrying amount.
- If fair value less than carrying amount, impairment recognized.

Restoration of Impairment

1. Assets held for use: impairment loss may not be restored.
2. Assets held for disposal: can be written up or down, as long as write-up is never greater than carrying amount before impairment.

- Losses or gains reported as “income from continuing operations”.

Presentation of Intangibles

1. Contra accounts are not normally shown
2. On the balance sheet, all intangible assets should be reported as a separate item
3. On income statement, amortization expense and impairment losses should be presented as part of income from continuing operations
4. Unless goodwill impairment loss is associated with discontinued operations, it should also be reported as part of continuing operations

For example:

If the carrying amount of an asset is reduced through impairment recognition from $1,000,000 to $100,000 and its useful life is compressed from 5 years to two years, then the annual rate of amortization would change from $200,000 per year to $50,000 per year.

If the useful life of the asset is instead **indefinite**, then you cannot amortize it. Instead, **periodically evaluate** the asset to see if it now has a determinable useful life. If so, begin amortizing it over that period. Alternatively, if the asset continues to have an indefinite useful life, periodically evaluate it to see if its value has become impaired.

If the intangible asset is goodwill, then you cannot amortize it under any circumstances. Instead, periodically evaluate it to see if its value has become impaired.

Research and Development Costs

Research activities involve:

1. planned search or
2. critical investigation aimed at discovery of new knowledge

Example:

Laboratory research aimed at discovery of new knowledge

Research and Development Costs

Development activities include:

- translation of research findings or other knowledge into a plan or design for a new product or process

- or –

- significant improvement to an existing product or process whether intended for sale or for use

R & D costs involve: searching for new products and processes

R & D costs are expensed unless the costs have alternative future uses

Examples:

1. Lab costs aimed at new knowledge
2. Conceptual formulation of possible product

Non R & D costs are expensed, if future benefits are uncertain

Presentation of R & D Costs

Disclosure is required in the financial statements of the total R & D costs charged to expense each period for which an income statement is presented.