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RECOGNITION OF INTANGIBLES: A POLICY REVIEW FOR INDIAN COMPANIES

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ABSTRACT

The value attached to intangible assets has increased manifold in the current era of knowledge economy. And the topic of intangibles has still been controversial and source of debate for many years. Various definitions, classifications and measurement methods have been suggested over the past few years in order to provide a better understanding and to promote communication between researchers, management and users of financial information. Given this background the objective of this study is to evaluate and highlight the classification adopted for intangibles by national and international accounting standards and how national and international accounting standards approaches intangibles with regard to their initial and subsequent recognition and measurement thus explaining why some intangible items are not included in the balance sheet of a company. Further, the study reviews the accounting for changes in value of intangible assets provided under national and international accounting standards.

KEYWORDS

intangible assets, Indian companies.

INTRODUCTION

To begin with, we all know that a balance sheet is nothing but a representation of assets and liabilities of a company at any particular point of time. Further we know, assets are expenditures made with intention of earning future economic benefits. And such expenditure is capitalized and shown as assets in a balance sheet.

Assets may be grouped in different ways but the one recommended by the Schedule VI of the companies act, 1956 and the one welcomed and accepted by the regulatory authority of India is the classification of assets into three major categories i.e. tangible assets, financial assets and intangible assets. And this paper focuses on third category of assets i.e. Intangible assets as these are becoming more and more vital to firms (Pankaj Madhani, 2007). And the main reason for the increased emphasis on intangible assets is the transition of economy from being industrial to knowledge-based. In knowledge-based economy, intangible assets comprises a significant percentage of the overall value of businesses. And intangible assets are increasingly considered the ultimate roots of company's success (Baglieri and Grando, 2009).

With the growing value of intangibles, problem of accounting for intangibles has also become an important problem especially for standard setting organizations (K.H Knivsfle, 2000). Traditionally, resources spent on intangibles assets have not been treated as valuable investments (H. Krohn, 2000) and were thus treated as costs. However, capitalizing and then amortizing intangible assets over their useful lives will more properly match costs with future benefits and will also increase the in-formativeness of financial statements (Nils E Joachim and Kjell Henry, 2000).[1]

But since intangibles are difficult to record objectively, the value – relevance of financial statements may be reduced if doubtful or even non – existing assets will be recorded. Therefore, for recognizing intangible assets a trade-off between the relevance and the reliability of intangible asset capitalization affect on in-formativeness of accounting should be determined.

In general, it is said that in order to improve the in-formativeness and hence the value relevance of the financial reports, intangibles, irrespective of their type, should be capitalized and subsequently amortized over their useful lives, provided they meet the asset recognition criteria (Mindy Wolfe, 2009). And if the asset recognition criteria are not met, intangible resources should be expensed in the same period in which they are incurred. Thus, the present study focuses on review of national and international accounting standards with respect to recognition and measurement of intangible assets.

LITERATURE REVIEW

In the above subject, Herve stolowy & Anne Jeny's (1999), examined how national and international accounting standards approach intangibles, both in terms of definition and treatment. Nils E. Joachim, Hoegh Krohn and Kjell Henry Knivsfla (2000), suggests that capitalizing and then amortizing intangible assets over their useful lives will more properly match costs with future benefits, and will increase the in-formativeness of financial statements. Baruch Lev (2003), discussed the accounting problems related to disclosure of internally generated intangible assets. Claire Eckstein (2004), reviewed existing and recently promulgated US, UK and IASC accounting standards relating to intangibles. Lloyd Austin (2007), believe that that even accounting standard setters are aware of the potential information gaps in the reporting of intangible assets both before and after the adoption of IAS 38. Douglas j. Skinner (2007), focused his attention on evaluating the current set of policy proposals for accounting of intangibles. Ragini Chandra (2009), in her comparative study on corporate disclosure practises on intangibles concluded that Indian companies lag behind as compared to the Japanese and US companies through multi regression analysis. Cao Yun-Hang (2009), through his analysis puts emphasis on the nature, classification, recognition and measurement of intangible assets and provides the choice of recognition and measurement. Vinny Munjal and Gauri Sikka (2010), focussed on the fact that it is very much the - unseen, immeasurable, unaccountable, unique advantages a business has that makes it stand out from the rest i.e. the intangible assets. and their valuation. Dr. Pandya Hemal and Ms. Jain Ankita (2015), examined the relationship between the intangible assets and firm's value for the companies in India. The study concludes that there is a positive relationship between the intangible assets of a firm and its value.

RESEARCH METHODOLOGY

This study actually stands on the border between two fields of research, international accounting and classification of intangible assets. Six categories of research into international accounting can be identified, as defined by Walton, Haller and Raffournier (1998):

- analysis of different sets of practices, or country studies;
- investigation of differences, or comparative studies;
- analysis of the reasons for differences;
- classification of different sets of practices;
- evaluation of accounting harmonization;
- investigation of the impact of international accounting diversity.

Our work falls into the scope of a comparative study. The main objective of this study is to examine the approach to intangibles in India and the classification of intangibles in financial statements, and to do so through international comparison. Finally, given the context of global harmonization, it is interesting to observe the points of convergence and divergence between national and international approach to intangible assets.

INFORMATION GATHERING

Information was gathered from the original official documents themselves and from the various past studies.

PROCEDURE

As our objective was to understand the accounting approach applied to intangibles in India and internationally, we grouped the information under three major themes. We looked first at the types of definition for intangibles, then at the recognition criteria for intangibles. Finally, we examined the recommended ways of accounting for changes in the value of intangible assets. At the end, summary of definition,recognition and changes in value of intangibles and accounting treatment for intangibles is given.

RECOGNITION OF INTANGIBLE ASSETS – NATIONAL AND INTERNATIONAL APPROACH

Before discussing about recognition of intangibles it is imperative to discuss 'what actually intangibles mean'???

As the English word 'tangible' has come from the Latin word 'tangere' which means 'to touch', so 'intangible' is something that cannot be touched physically, but most of the time it is understandable or even felt in the heart. From business point of view, "an intangible asset is a claim to future benefits that does not have a physical or financial embodiment." Examples of possible intangible assets include: Brands, computer software, patents, copyrights, motion picture films, customer lists etc. All these intangible assets are very dissimilar in nature but they still have one element in common i.e. they create value for a firm and their size and nature determine a firm's future earning potential in terms of value creation (Pankaj Madhani, 2007).

RECOGNITION AND MEASUREMENT OF INTANGIBLE ASSETS

Despite of various issues involved in recognition and measurement of intangible assets, the criteria for recognition of intangible assets given in accounting standards are in- dissociable from the thinking behind the way they are defined. When the approach applied in defining intangibles turns out to be conceptually weak, the recognition criteria compensate for the gaps left.[2]

[3]Almost in all the countries purchased intangibles are being capitalized by the companies but when comes to internally generated intangibles they do not generally capitalize the intangibles. However, this is the general trend throughout the world and in the present study we are more concerned about Indian companies. Therefore, here is the review of Indian standards and the International standards in detail with regard to intangible accounting which can help to give a better vision to companies in India and know their state at international level. Intangibles accounting is regulated by International Accounting Standard – IAS 38, globally and in India it is regulated by Accounting Standard – AS 26. Here is the review and comparison of both i.e. IAS 38 and AS 26.

INITIAL RECOGNITION AND MEASUREMENT

A. INTERNATIONAL ACCOUNTING STANDARD – 38 (IAS – 38)

The standard defines an intangible asset as "an identifiable non-monetary asset without physical substance". Identifiable means that the asset is either separable i.e. it can be sold apart from the firm's other assets or it arises from contractual or other legal rights.

IAS 38 applies to all intangible assets other than to the financial assets; to exploration and evaluation assets (comes under extractive industries); to expenditure on the development and extraction of minerals, oil, natural gas and similar resources; to intangible assets arising from insurance contracts and to those intangible assets which are covered by other IFRS (such as intangible held for sale, lease assets and goodwill, as goodwill is covered by IFRS 3).

A.1 RECOGNITION CRITERIA

IAS 38 requires an entity to recognize an intangible asset, obtained in any way, at cost if and only if – the asset is identifiable, it is probable that the future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably. But if an intangible item does not meet both the definition and the criteria for recognition as an intangible asset, then IAS 38 requires that the expenditure on intangibles should be recognized as an expense when it is incurred. The standard also prohibits an entity from subsequently reinstating at a later date, any expenditure as an intangible asset that was originally charged to expense.

IAS 38 provides that intangibles can be obtained by the firm:

1. Internally -
   By self-creation, that is internally generated by the firm
2. Externally -
   By separate purchase;
   By an exchange of assets; and
   As part of a business combination

1) INTERNALLY GENERATED INTANGIBLE ASSETS

The rules to recognize internally generated intangible assets are much more stringent. Following the approach of the earlier research and development standards, costs on internally generated assets is considered over time. Only when specific criteria have been met, the expenditure can be accumulated as an asset. The standard prescribes two phases of expenditure:

The research phase;
The development phase

Research is "original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding". Examples include the search for new knowledge or for alternatives for materials, devices, products or processes etc. Such costs are considered as too distant from and unconnected with probable future benefits to comprise assets and must be expensed.

At some point the costs may enter the development phase and can then be capitalized as assets in the balance sheet. To meet the capitalization criteria the entity must show that:

1. It is technically feasible to complete the intangible asset, to either use or sell it.
2. They will be able to use or sell the intangible asset.
3. The intangible asset is able to produce future benefits. If it is to be sold, the existence of a market must be established. If kept, it usefulness must be demonstrated.
4. They have the technical, financial and other resources to complete the asset.
5. The costs in the development phase are able to be measured reliably.

However, any expenditure made on the asset before the criteria are satisfied cannot be recognized as part of the asset's cost and must remain expensed in the period they were incurred. Thus the expenditures which are recognized for an internally generated intangible asset may not comprise its entire cost.

2) EXTERNALLY ACQUIRED INTANGIBLE ASSETS

2.1 ACQUISITION BY SEPARATE PURCHASE

Where intangible assets are separately purchased, the probability of generating future benefits is always considered to be satisfied, the argument being that rational firms would only outlay the costs if they were reasonably certain to obtain the future benefits. Such assets should be recognized in the balance sheet, initially at their cost price. In certain restrictive circumstances, they may be re-valued later.

2.2 ACQUISITION BY EXCHANGE OF ASSETS

Intangibles arising from an exchange of assets are treated similarly to asset purchases and are usually recognized at the fair value of the intangible asset acquired or the asset exchanged whichever is the more clearly determined.

2.3 ACQUISITION AS A PART OF BUSINESS COMBINATION

The restrictions on the recording of internally generated intangible assets apply at the individual company level, but when the assets of a firm are part of a "business combination" the rules change. The significance of this process is that IAS 38 allows intangibles, which may not have passed the recognition test at the individual subsidiary company level (and are therefore excluded in the subsidiary's accounts), to be recognized when the assets of the subsidiary are added to those of the parent to form the consolidated balance sheet. The previously unrecognized intangibles are treated similarly to purchased or externally acquired intangibles.

If the fair value of the separable intangible assets can be reliably measured, they can be recognized in the consolidated balance sheet. Otherwise they are recognized in goodwill. The recognition of the separable intangible assets at their fair value would appear to contradict the IAS 38 requirement to initially record intangible assets at cost. However, the presumption is that, as the company was acquired by the parent at the market price, the intangibles were purchased at fair value as well.

B. ACCOUNTING STANDARD – 26 (AS – 26)

The standard is parallel and similar to IAS 38 and it defines an intangible asset as an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Accounting Standard (AS) 26 – 'Intangible Assets', issued by the council of the Institute of Chartered Accountants of India (ICAI), comes into effect in respect of expenditure incurred on intangible items on almost all enterprises from 01-Apr-2003 and comes into effect from 01-Apr-2004 for any leftover enterprises and is mandatory in nature from that date.

B.1 RECOGNITION CRITERIA

The standard is parallel with IAS 38 in setting up the recognition criteria also. An enterprise to recognize any item as an intangible asset requires to demonstrate that the item meets the definition (as stated in above paragraph) of an intangible asset and if the cost of that asset can be measured reliably and if it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise. This is applicable to all intangible assets whether it is obtained externally or it is generated internally by the enterprise itself.

Further, we will discuss the recognition criteria for both the categories of intangibles in detail i.e. internally generated and externally acquired intangible assets:

1. INTERNALLY GENERATED INTANGIBLE ASSETS

To assess the internally generated intangible assets, in addition to complying with the general requirements for the recognition and the initial measurement of an intangible asset, an enterprise is required to classify the generation of the asset into:

- A research phase; and
- A development phase.

Research Phase – The intangible asset arising from research or from the research phase of an internal project should not be recognized as asset. Thus, expenditure on research should be recognized as an expense when it is incurred. It is because in the research phase of a project, an enterprise cannot demonstrate that an intangible asset exists from which future economic benefits are probable.

Development Phase – The intangible asset arising from the development or from the development phase of an internal project should be recognized if and only if an enterprise can demonstrate that

- It is technically feasible to complete that intangible asset so that it will be available for use or sale;
- The enterprise has the intention and ability to complete the intangible asset and use or sell it;
- The enterprise has the ability to measure the expenditure attributable to the intangible asset during the development reliably;
- The intangible asset will generate probable future economic benefits to the enterprise;
- The enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself, if it is to be sold or if it is to be used internally, then the usefulness of the intangible asset.[4]

Therefore, if an enterprise successfully demonstrates the above mentioned things then, it can identify and recognize an item as an intangible asset in the balance sheet at cost. The cost for this purpose is the sum of expenditure incurred on internally generated intangible asset from the time when it first meets the recognition criteria.

2. EXTERNALLY ACQUIRED INTANGIBLE ASSETS

2.1 ACQUISITION BY SEPARATE PURCHASE

If an intangible asset is acquired separately, then there is no question of its identifiability and certainly its cost can be measured reliably. Such intangible assets are recognized in balance sheet at cost which comprises of its purchase price, any import duties and other taxes paid by the enterprise, and any other expenditure that is directly attributable in making the asset ready for its intended use.

And if an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, then such asset is recorded at its fair value or the fair value of the securities issued, whichever is more clearly evident.

2.2 ACQUISITION BY EXCHANGE OF ASSETS

An intangible asset may be acquired by an enterprise in exchange or part exchange for another asset. In such case also, the intangible asset will be recorded at cost and the cost of the intangible asset so acquired in exchange is determined in accordance with the principles laid down in this regard in Accounting Standard 10 – Accounting for Fixed Assets, which says when a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given.

2.3 ACQUISITION AS A PART OF AMALGAMATION

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with Accounting Standard 14 – Accounting for Amalgamation. The transferee company recognizes an intangible asset that meets the recognition criteria (as already stated), even if any intangible asset had not been recognized in the financial statements of the transferor, at the cost i.e. fair value of that asset if it can be measured reliably and if it's fair value cannot be measured reliably than that asset is not recognized as a separate intangible asset but is included in goodwill.

2.4 ACQUISITION BY WAY OF GOVERNMENT GRANT

In some cases, an intangible asset may also be acquired free of charge or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates intangible assets to an enterprise such as airport landing rights, licenses to operate radio or television stations etc. For such assets, the standard says that recording should be done in accordance with the principles laid down in Accounting Standard 12 – Accounting for Government Grants.

And AS 12 requires that if a government grant in the form of non-monetary assets i.e. intangible assets, is given free of charge, it should be recorded at a nominal value and if it is given at a concessional rate, it should be accounted for on the basis of its acquisition cost.

SUBSEQUENT MEASUREMENT AND RECORDING

A. INTERNATIONAL ACCOUNTING STANDARD – 38 (IAS – 38)

A.1 SUBSEQUENT EXPENDITURE ON EXISTING INTANGIBLE ASSETS

Subsequent expenditure, on an intangible asset shall be recognized as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria.

A.2 SUBSEQUENT MEASUREMENT OF INTANGIBLES

For subsequent measurement, an entity must choose either the cost model or the revaluation model for each class of intangible asset. But if an intangible asset is accounted for by using the revaluation model, all the other assets in its class shall also be accounted for by using the same model.

1. SUBSEQUENT MEASUREMENT UNDER COST MODEL – After initial recognition, upon subsequent measurement of intangible assets under cost model, assets should be carried at cost less accumulated amortization and impairment losses if any.

Carrying Amount = Cost – (Accumulated Depreciation + Impairment Loss) (Eq.- 01)[5]

Carrying Amount – Amount at which intangible asset is now to be recorded;
Cost – Cost at which intangible asset was initially measured;
Accumulated Depreciation – Cumulative depreciation up to current period;
Impairment Loss – Amount by which recorded value of intangible asset exceeds its realizable amount.

2. SUBSEQUENT MEASUREMENT UNDER REVALUATION MODEL – Revalued amount is asset's fair value less any subsequent amortization and impairment losses and vice-versa. But for intangibles, to qualify for revaluation, IAS 38 imposes an extra requirement which does not apply to tangible assets, that is the fair value must be obtained with reference to an active market for that asset.

Carrying Amount = Fair Value – (Accumulated Depreciation + Impairment Loss) (Eq. - 02)

Carrying Amount, Accumulated Profit & Impairment loss as stated in Eq. -01;
Fair Value – The amount at which the asset can be exchanged between knowledgeable and willing parties in an arm's length transaction;

But as active markets for intangible assets are uncommon, thus revaluations are also expected to be uncommon. Further, revaluations must be made with such regularity that at the end of the reporting period, the carrying amount of the intangible asset does not differ materially from its fair value.

As a result of revaluation, if an intangible asset's carrying amount is increased, the increase shall be recognized in other comprehensive income and accumulated in equity under the heading of revaluation surplus. On the other hand, the decrease in intangible asset's carrying amount shall be recognized in profit or loss. However, the decrease shall be recognized in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset.

3. CALCULATION OF AMORTIZATION AND IMPAIRMENT - For calculating amortization or impairment either under cost model or revaluation model, IAS 38 requires an entity to assess the useful life of its intangible assets into those with finite and those with indefinite lives.

An intangible asset shall be regarded to have indefinite life when, based on analysis of all the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. On the contrary, if the asset is expected to generate economic benefits for a limited period to the entity, then it shall be regarded to have finite life.

Further, in case of intangible assets having finite life, the entity shall assess the length of its useful life or number of production or similar units constituting that useful life. The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or such other legal rights. In addition, IAS 38 imposes a rebuttable presumption that the maximum amortization period is 20 years.

3.1 CALCULATION OF AMORTIZATION FOR INTANGIBLE ASSETS HAVING FINITE USEFUL LIVES

The amortization/depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life or a period of 20 years whichever is shorter.

Depreciation = Cost of Asset – Residual Value of Asset

3.2 CALCULATION OF AMORTIZATION FOR INTANGIBLE ASSETS HAVING INDEFINITE USEFUL LIVES

IAS 38, an intangible asset with an indefinite useful life shall not be amortized rather an entity is required to test an intangible asset with an indefinite useful life for impairment in accordance with the principles of IAS 36 – Impairment of Assets, by comparing its recoverable amount with its carrying amount annually and whenever there is an indication that the intangible asset may be impaired.

Impairment Loss = Carrying Amount – Recoverable Amount

In case, recoverable amount is more than the carrying amount then it will be accounted for as impairment profit.

And the useful life of an intangible asset that is not being amortized shall be reviewed each reporting period i.e. each financial year to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not support, then such change in the useful life assessment from indefinite to finite shall be accounted for.

A.3 RETIREMENTS AND DISPOSALS

An intangible asset shall be de-recognized on disposals or when no future economic benefits are expected from its use or disposal. And such gain or loss arising from the de-recognition of an intangible asset shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It shall be recognized in profit or loss when the asset is de-recognized.[6]

B. ACCOUNTING STANDARD – 26 (AS - 26)

B.1 SUBSEQUENT EXPENDITURE ON EXISTING INTANGIBLE ASSETS

Subsequent expenditure on an intangible asset after its purchase or its completion (in case of internally generated intangible asset) should be recognized as an expense when it is incurred unless:

- It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and
- The expenditure can be measured and attributed to the asset reliably.

If these two conditions are met, then the subsequent expenditure should be added to the cost of the intangible asset. But subsequent expenditure on a recognized intangible asset is recognized as an expense if such expenditure is required to maintain the asset at its originally assessed standard of performance (AS 26).

B.2 SUBSEQUENT MEASUREMENT OF INTANGIBLES

As per AS 26, after the initial recognition, an intangible asset should be carried at its cost less any accumulated amortization and any accumulated impairment losses.

Carrying Amount = Cost – (Accumulated Depreciation + Impairment Loss)

This standard adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years. Here AS 26 is slightly different from IAS 38 as it does not classifies intangible assets into those having finite lives and those having indefinite lives for calculating accumulated depreciation and so for the method of their subsequent measurement.

CALCULATION OF AMORTIZATION

As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved in the way of charging amortization or depreciation,

Depreciation = Cost of Asset – Residual Value of Asset

And such depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life (to the maximum of ten years due to the rebuttable presumption in this regard) from the date when the asset is available for use.

B.3 RETIREMENTS AND DISPOSALS

An intangible asset should be de-recognized i.e. eliminated from the balance sheet on disposal or when no future economic benefits are expected from its use and subsequent disposal. The gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognized as income or expense in the statement of profit or loss.

CONCLUSION

It is concluded that the value attached to intangible assets has increased manifold in the current era of knowledge economy. And the topic of intangibles has still been controversial and source of debate for many years. Various definitions, classifications and measurement methods have been suggested over the past few years in order to provide a better understanding and to promote communication between researchers, management and users of financial information. Given this background the objective of this study is to evaluate and highlight the classification adopted for intangibles by national and international accounting standards and how national and international accounting standards approaches intangibles with regard to their initial and subsequent recognition and measurement thus explaining why some intangible items are not included in the balance sheet of a company. Further, the study reviews the accounting for changes in value of intangible assets provided under national and international accounting standards.

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