

Accounting for Intangible Assets

Suggested Solutions

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Motivation

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“massive investment in intangible assets in the last two decades ... and the non-recognition of investments in intangible assets in the financial statements distorts the measurement of an enterprise’s performance and does not allow an accurate assessment of returns on investment in intangible assets.

... research studies “establish that capitalisation of research and development expenditure yields value-relevant information to investors.”

IAS 38, Staff Basis for Conclusions, 1998

2

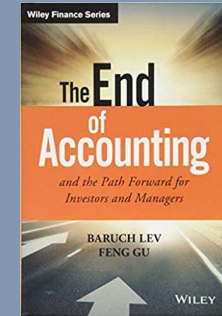
“Over the last 15 years or so there have been a number of calls for accounting reforms, with claims that the traditional historical cost approach has outlived its usefulness. One of the claims made in this debate is that the economy has changed in fundamental ways, that business is now fundamentally ‘knowledge based’ rather than industrial, and that ‘intangibles’ are the new drivers of economic activity.

Based on those claims, commentators contend that one of the key problems faced by financial reporting is that financial statements fail to recognise many of the most important knowledge-based intangibles, such as intellectual capital, and that this has adversely affected investment in intangibles. This has led to calls for accounting-standard setters to re-evaluate how intangibles are accounted for and to make reforms.”

Skinner (2008)

3

- Intangibles are increasingly important
- Financial reporting does not reflect intangibles
- Divergence between book and market values



4

- Standard setters unresponsive
- Move 'intangibles' from the 'too difficult tray' to the 'lets think about it' tray

5

- What can be done within financial statements?
- Role of intangibles within the entity's business model
- And narrative reporting

Accounting for (intangible) Assets within a Double-entry System

The Presumed Objective of Accounting for Intangible Assets

To provide information about:

1. the amount, timing, and uncertainty of future cash flows
2. management performance and custodianship

Sounds familiar?

Accounting is within a Double-Entry System of Balance Sheets and Income Statements

How can that accounting system be utilized to report on (intangible) assets?

The double-entry system....

.... has features that can be exploited for communicating the value of assets

but....

....the systems constrains what can be communicated

Determining Features of the Double Entry System

1 The value of (intangible) assets cannot be communicated via the balance sheet. With few exceptions, there is no stand-alone value for a brand, “knowledge capital”, “human capital”, “organizational capital”, fixed assets,

- *Value in business is generated under an entrepreneurial idea that employs assets jointly to generate value (cash flows) for investors.*
- *Management are to be judged on their entrepreneurial ideas and the execution of those ideas in employing assets jointly.*

Determining Features of the Double Entry System

- 2 For every debit, there must be a credit. That credit must have an interpretation to be communicated.

What is the credit entry for recognizing the following as assets.....

- *Organizational capital?*
- *Social capital?*
- *Political capital?*
- *Location?*

..... income? Increase is equity?

Determining Features of the Double Entry System

- 3 Investment expenditures in assets have an interpretable credit: Cash, kind, or a liability to pay cash or kind

The systems limits the recognition of (intangible) assets to expenditures

- 4 Separability: Expenditure on (intangible) assets are difficult (impossible?) to determine when expenditures are made jointly with current expenditures.

Human capital

Advertising for brand building

Investment in customer loyalty programs and supply chain relationships

Determining Features of the Double Entry System

- 5 The value of assets cannot be communicated via the balance sheet, but the double-entry system also produces an income statement

Earnings (in the income statement) is a summary number from using assets jointly to generate value

*Thus, the accounting for assets in the balance sheet must be determined with the effect on the income statement in mind
The income statement effect is via amortization of the booked asset*

Determining Features of the Double Entry System

6

The amount of uncertainty surrounding the investment determines amortization error and thus capitalization in the balance sheet

What is the ex ante amortization rate against future revenues for R&D into a drug remedy where there is no product as yet, no customers, no revenue

If the probability of success is 1%, the probability of a future impairment is 99%. Rational expectations says: Impair now

Punch line

Asset recognition of separable expenditures must be made with regard to consequences for the income statement

Amortization of capitalized (intangible) assets can upset the income statement as a communication of the value from using assets jointly. That effect increases with the amount of uncertainty about investment outcomes.

But....expensing of investment also affects the income statement.

Solutions involve coming to grips with this tension....

*..... to provide information about the amount, timing, and **uncertainty** of future cash flows and management stewardship in delivering those outcomes under uncertainty*

Financial reporting solutions

- In principle, there are four 'solutions' to accounting for intangibles
 1. Expense
 2. Asset
 3. Threshold for capitalisation
 4. Conditional capitalisation

1. Expense

- The practical default whenever the investment/asset component of expenditure cannot be separately identified
- For separately identifiable investment
 - Expensing responds to (future) mismatching, and asset overstatement, under conditions of high outcome uncertainty
 - Yet expensing can also lead to mismatching that frustrates valuation based on earnings
 - Separate income statement presentation can alleviate this frustration

- Example – Facebook

	2019	2018
Revenue	70,697	55,838
Cost of revenue	12,770	9,355
Research and development	13,600	10,273
Marketing and sales	9,876	7,846
General and administrative	10,465	3,451
Income from operations	23,986	24,913
Finance expense	826	448
Tax	6,327	3,249
Net income	18,485	22,112

2. Asset

- Requires that the investment/asset component of expenditure can be separately identified
- An often-proposed solution to the 'problem' of unrecognised intangibles
- Yet if there is a high probability of impairment, the claim to an asset is dubious
- In addition
 - Standalone value problematic and measurement is typically at cost, suggesting information via the income statement
 - In the presence of high outcome uncertainty, there is income statement mismatching, either arbitrary amortisation or (expected) impairment

3. Threshold for capitalisation

- Requires that the investment/asset component of expenditure can be separately identified
- Recognise an asset when an ex ante amortisation schedule can be established which, based on evidence, results in low ex post mismatching errors
- This is balance sheet recognition in the service of providing information via the income statement
- Aligns with concept of control in the Framework

4. Conditional capitalisation

- Requires that the investment/asset component of expenditure can be separately identified
- Investments that do not meet the threshold for capitalization are expensed, to a separate part of the income statement.
- If, as time evolves, it becomes likely that the investment will pay off, then capitalization occurs at the threshold point when, ex ante, subsequent amortization renders an informative income statement conveying value added to the investment.
- The accumulated balance of the expensed investment account could include disclosure of the costs associated with investments that have been abandoned, informing an investor of successes, failures and the expenditure related to investments still being pursued.
- Aligns with off-balance sheet disclosure.

Implications of 3 and 4

- Income statement
 - Current (matched) expenditure
 - No investment (e.g. Facebook's cost of revenue, or SG&A)
 - Amortisation of prior investment
 - Impairments (unexpected)
 - Exploratory expenditure (uncertain investment, e.g. Facebook's R&D)
 - Ex post capitalisations (reversals)
- Balance sheet
 - Assets recognised on the basis of outcome (un)certainty
 - (In)tangibility per se not relevant

How Existing IFRS Standards Contrast with the Solutions

Recognition – IAS 16 versus IAS 38

The recognition criteria are almost identical

Table 1: Differences between IAS 16 and IAS 38

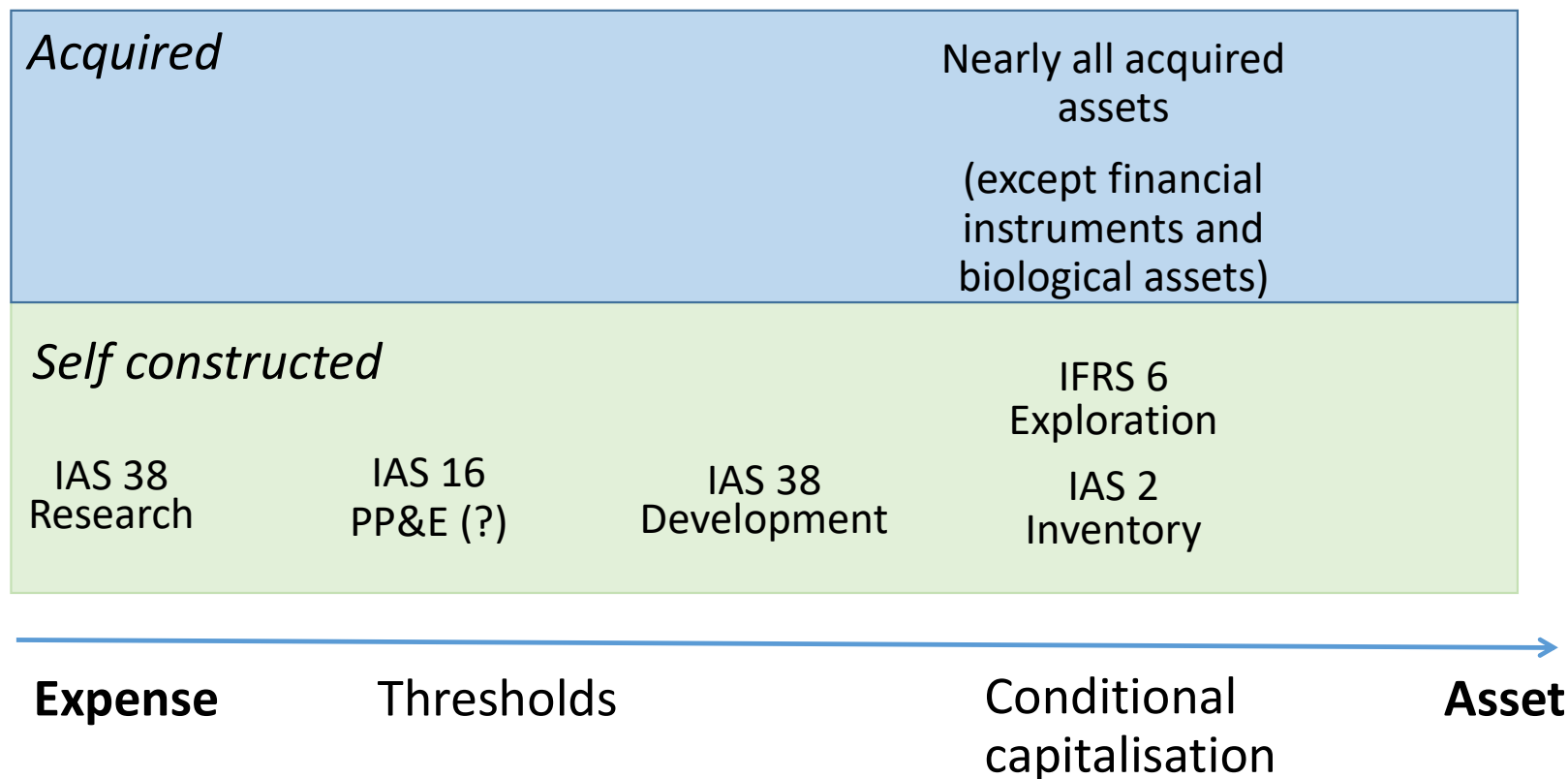
Recognition basis	All internally generated assets must meet six specific recognition criteria as well as the general recognition criteria. Additional requirement to place more reliance on external sources of evidence and to consider the benefits over the life of the intangible asset.
Specific prohibitions	IAS 38 identifies some expenditure that is prohibited from being recognised as an internally generated intangible asset (brands, mastheads, publishing titles, customer lists and items similar in substance, training activities, advertising and promotional activities (including mail order catalogues)
Fair value model	Must be an active market for the intangible asset
Impairment	All indefinite-life intangible assets must be tested for impairment every reporting period.
Residual value	Intangible assets are assumed to have zero residual value.

Conditional capitalisation

- Examples in practice
 - Extractive activities
 - Project accounting
 - Acquired intangibles
 - Pre-approval inventory
- Disclosure
- Revised IFRS Framework
 - Shift to reflecting uncertainty in measurement

Financial reporting solutions

Initial recognition of expenditure



Tangibility

- The distinction between tangible and intangible (and financial) assets has become increasingly blurred
 - Leases assets
 - Robotics
 - Cryptocurrencies
- Revised IFRS Framework
 - Rights approach to assets – all rights are intangible

Some conclusions

- The analysis leads to limited recognition in cases where cost identification/separability is challenging, and outcome uncertainty is high. Other than in 'steady state', the informational signal in earnings is distorted.
- Understanding how the double-entry system conveys information therefore points to additional disclosure that may be required when that system is limiting.
- A useful approach here is to consider 'resources' rather than 'assets', in other words to 'reverse' the lens conventionally applied by the IASB, and to start with presentation and disclosure, rather than with recognition and measurement.
- These issues are not concerned with tangibility, which is a conceptual diversion
 - IAS 16 vs IAS 38 presumes a distinction not supported by the Framework, that tangibility is an economic attribute
 - The recognition threshold in IAS 38 is significantly higher than for tangible assets
 - Certain investments can be arguably either tangible or intangible, or comprise elements of both

We welcome your comments ... !