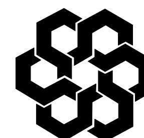

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers.

INFORMATION FOR OBSERVERS

Board Meeting: **23 January 2007, London**

Project: **Intangible Assets**

Subject: **Draft Preliminary Technical Paper (Agenda Paper 3C)**

EXECUTIVE SUMMARY

INITIAL ACCOUNTING FOR INTERNALLY GENERATED INTANGIBLE ASSETS (Section 1)

Identification (Chapter 2)

The manner by which an intangible item comes into existence is not relevant to the determination of whether the item can be identified as an asset. Therefore, items of the same nature, irrespective of whether they are acquired in a business combination or internally generated (planned or unplanned), should be analysed in the same way for the purpose of determining whether they are assets. The principles and guidance for identifying the existence of and describing an intangible asset acquired in a business combination specified in IFRS 3 and IAS 38 should be adopted for assessing whether internally generated intangible assets exist. On that basis a technique based on a hypothetical business combination is a suitable technique for identifying internally generated intangible assets. (para 50)

Recognition (Chapter 3)

If a cost-based model is adopted	*If a valuation-based model is adopted*
Only planned internally generated intangible assets should be contemplated for recognition under a pure cost-based model. They do not warrant specific recognition criteria other than specification of the meaning of 'planned'. Accordingly, all planned internally generated intangible assets that satisfy the *Framework* recognition criteria of 'probable future economic benefits' and 'reliable measurement of cost' should be recognised. (para 71)	Internally generated intangible assets do not warrant specific recognition criteria that differ from those adopted for intangible assets acquired in a business combination. Accordingly, all planned and unplanned internally generated intangible assets that satisfy the *Framework's* and IFRS 3's recognition criterion of 'reliable measurement of value' should be recognised. (para 88)

<table>
<tr><th colspan="2">Measurement (Chapter 4)</th></tr>
<tr><th>If a cost-based model is adopted</th><th>If a valuation-based model is adopted</th></tr>
<tr><td>The principles for allocating costs to other types of assets should be adopted for planned internally generated intangible assets from the commencement of implementing the plan up until completion or abandonment of the plan. (para 105)
It is reasonable to presume that historical cost can be reliably measured for all planned internally generated intangible assets. A transitional period may be warranted to allow entities time to develop adequate accounting systems. Cost is not applicable to unplanned internally generated intangible assets, because there is no basis for reliably attributing costs. (para 109)</td><td>Internally generated intangible assets are capable of being reliably measured at fair value to the same degree that IFRS 3 asserts that the fair value of the same types of intangible assets acquired in a business combination are capable of reliable measurement. Consistent with the emerging view from the Business Combinations Phase II project, SFAS 157 provides a suitable basis for specifying the determination of fair value of internally generated intangible assets. (para 137)</td></tr>
<tr><td colspan="2">On balance, consistent with the principles in IFRS 3, both planned and unplanned internally generated intangible assets should be required to be initially measured at fair value (as that notion is applied in SFAS 157) where fair value can be estimated with an acceptable level of reliability. (para 149)</td></tr>
<tr><th colspan="2">Presentation/Disclosure (Chapter 5)</th></tr>
<tr><td colspan="2">Note disclosure of internally generated intangible assets is not a satisfactory substitute for recognition. (para 163)</td></tr>
<tr><th>If a cost-based model is adopted</th><th>If a valuation-based model is adopted</th></tr>
<tr><td>The costs relating to the period and reliably attributable to a planned internally generated intangible asset should be disclosed. Arguably, the accumulated costs that are reliably attributable should also be disclosed. (para 177)
Entities should disclose the reasons for capitalising expenditures reliably attributable to a planned internally generated intangible asset. (para 181)</td><td>The methods and significant assumptions applied in determining an internally generated intangible asset's fair value, including the extent to which the asset's fair value was determined directly by reference to observable prices or was estimated using other valuation techniques, should be disclosed. In addition, if changing one or more of the assumptions used to determine the fair value to reasonably possible alternative assumptions would change the fair value significantly, the entity should state this fact and disclose the effect of those changes. (para 190)
The costs reliably attributable to an internally generated intangible asset should be disclosed. (para 195)
Where an internally generated intangible asset is measured provisionally at balance date, that fact should be disclosed together with an explanation of why this is the case. (para 197)</td></tr>
<tr><td colspan="2">In each period when an internally generated intangible asset does not meet the relevant recognition criteria, whether under a cost-based model or a valuation-based model, entities should provide a description of the asset and the reason why the asset fails to meet the relevant recognition criteria. (para 204)</td></tr>
</table>

INITIAL ACCOUNTING FOR SEPARATELY PURCHASED INTANGIBLE ASSETS (Section 2) *[under development as at December 2006]*	
SUBSEQUENT ACCOUNTING FOR INTANGIBLE ASSETS (Section 3) *[not commenced as at December 2006]*	

SECTION 1: THE INITIAL ACCOUNTING FOR INTERNALLY GENERATED INTANGIBLE ASSETS

Consistent with a common way of analysing accounting issues, while acknowledging the interrelationships between the various aspects, Chapters 1 to 5 first identify the accounting issue (Chapter 1) before analysing the issue from the perspectives of definition/identification (Chapter 2), recognition (Chapter 3), measurement (Chapter 4) and presentation/disclosure (Chapter 5).

CHAPTER 1 – INTRODUCTION

THE ISSUE

1. This Chapter and Chapters 2-5 consider the main issues relating to the initial accounting for internally generated intangible assets, including the identification, recognition, measurement and presentation/disclosure of such assets.

2. The Chapters do not consider the initial accounting for intangible assets acquired in a business combination. However, a focus is whether the principles adopted for the identification, recognition and measurement of intangible assets acquired in a business combination are suitable for the same kind of intangible assets if they were internally generated. Accordingly, the Chapters do not contemplate intangible items that would not be identified as intangible assets in the context of a business combination. Some argue that the principles in IFRS 3 *Business Combinations* are inappropriate even for intangible assets acquired in a business combination, and that many intangible assets should not be split from goodwill in a business combination. However, for the purpose of this project, the current requirements in IFRS 3 are accepted, including the definition of intangible assets and the distinction it draws for the purposes of separating intangible assets from goodwill.

3. The Chapters also consider whether the principles adopted for internally generated tangible assets (such as those in IAS 16 *Property, Plant and Equipment*) are suitable for internally generated intangible assets.

4. In developing this Paper, interviews were conducted with a limited number (fourteen, of which two could be categorised as users/analysts) of Australian constituents with experience in identifying, recognising and measuring internally generated intangible assets and using the resulting information. Australian constituents were selected because Australia is a jurisdiction in which, prior to the adoption of IFRS, accounting standards contemplated recognition and measurement of internally generated intangible assets in a broader range of circumstances than under IAS 38 *Intangible Assets*. Given the small number interviewed, it may not be appropriate to generalise from the findings. However, where relevant, each Chapter reflects on the comments made by the interviewees to add a pragmatic perspective to the conclusions drawn. Depending on the nature of the comments made by interviewees, they are presented either before or after the conclusions expressed in each Chapter and not necessarily in a separate section. Appendix A provides further details about the interviews and interviewees.

The Framework

5. The issues considered throughout this Paper are addressed within the context of the IASB's *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*). The joint project between the IASB and the FASB to develop a common conceptual framework (referred to in this Paper as the IASB/FASB Conceptual Framework project) is likely to result in changes to the *Framework*. Due to the uncertain outcomes of that project, this Paper refers to the existing *Framework*. In places, this Paper also refers to anticipated changes to the *Framework*. This is only done where it is apparent that the IASB has sufficiently developed its thinking, such as reflected in the Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* (July 2006) – referred to in this Paper as the IASB/FASB Preliminary Views Paper on the Conceptual Framework (July 2006). Subject to timing constraints, when the outcomes of the IASB/FASB Conceptual Framework project become clear, this Paper will be revised to reflect those outcomes.

6. Paragraph 12 of the *Framework* states that:

> The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.[1]

Paragraph 15 of the *Framework* notes that users are better able to evaluate the ability of an entity to generate cash and cash equivalents, including the timing and certainty of their generation, for the purposes of making economic decisions if they are provided with information that focuses on the financial position, performance and changes in financial position of an entity.[2] Paragraphs 24-42 of the *Framework* note that the four principal qualitative characteristics that make the information provided in financial reports useful to users are: understandability, relevance, reliability[3] and comparability. The initial accounting for internally generated intangible assets affects the information that is provided in financial statements and, therefore, the degree to which the objective of financial statements can be satisfied. If internally generated intangible assets exist and satisfy the recognition criteria for assets identified in the *Framework*, their non-recognition may limit the degree to which the objective of financial statements can be satisfied.

Arguments for not Recognising Internally Generated Intangible Assets

7. Many items that could be regarded as internally generated intangible assets have traditionally not been, and under IAS 38 are not permitted to be, recognised as assets in the balance sheet. This may be because in the past intangible assets were

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[1] This is broadly consistent with paragraph OB2 of the IASB/FASB Preliminary Views Paper on the Conceptual Framework (July 2006), which states: "The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions."

[2] This is broadly consistent with paragraph OB18 of the IASB/FASB Preliminary Views Paper on the Conceptual Framework (July 2006), which states: "To help present and potential investors and creditors and others in assessing an entity's ability to generate net cash inflows, financial reporting should provide information about the economic resources of the entity (its assets) and the claims to those resources (its liabilities and equity). Information about the effects of transactions and other events and circumstances that change resources and claims to them also is essential."

[3] The IASB/FASB Preliminary Views Paper on the Conceptual Framework (July 2006) contemplates 'reliability' being replaced by 'faithful representation', to de-emphasise the focus on verifiability that has developed around the notion of reliability (see, for example, paragraph BC2.26).

less important to entities relative to tangible assets. Non-recognition may also be due to, at least for some intangible assets, there being an absence of an attributable transaction to trigger their initial recognition or signify control. Furthermore, there may be perceived difficulties in identifying intangible assets or concerns about the point in time at which they come into existence and concerns about their reliable measurement, coupled with prudence. Concerns about reliable measurement arise in relation to both a cost model and a fair value model. For example, IAS 38 delays the time at which it contemplates costs being reliably attributable to an internally generated intangible asset arising from development activities until the entity can demonstrate that certain criteria are met (including technical and commercial feasibility of completion). Also, some express concern that the subjectivity involved in identifying, recognising and measuring internally generated intangible assets exposes financial reporting to a high degree of manipulation. Some further argue that investors would not act differently even if internally generated intangible assets were recognised, because, they assert, information about such assets is available from alternative sources, such as through disclosures in notes to financial statements or management briefings, and therefore it is not necessary to recognise them. It is also contended by some that the costs involved in identifying and reliably measuring many internally generated intangible assets outweigh the benefits that would be derived from their recognition. Lev[4] traces non-recognition to the unique attributes of intangible assets – high uncertainty regarding future outcomes, partial excludability (lack of full control) and nontradability (page 83).

Arguments for Recognising Internally Generated Intangible Assets

8. Lev (2001) is critical of the non-recognition of intangible assets. He argues that information deficiencies resulting from their non-recognition cause serious problems and social harm, including excessively high cost of capital for early-stage knowledge-intensive entities, systematic undervaluation by investors of intangibles-intensive enterprises, and risks of insider gains undermining confidence in the integrity of stock markets (pages 95-102).

[4] Lev B – ‘Intangibles: Management, Measurement and Reporting’, Brookings Institution Press, Washington 2001. (Referred to in this Paper as Lev (2001))

9. Furthermore, some commentators are critical of the apparent inconsistencies in the initial recognition and measurement of intangible assets acquired in business combinations under IFRS 3 compared with the initial treatment of the same types of internally generated intangible assets under IAS 38. Currently under IFRS 3 certain intangible assets acquired in business combinations are required to be recognised as assets and initially measured at fair value. In contrast, under IAS 38, the same types of intangible assets that were internally generated are either not permitted to be recognised or are required to be recognised under IAS 38 and measured at cost (based on costs incurred only after certain criteria are met, and therefore only partial recognition of costs), depending on the circumstances.

10. Several commentators interviewed for the purpose of this project (see Appendix A) noted that there is no necessary relationship between the existence of an intangible asset and the manner in which the intangible asset was obtained. Furthermore, treating internally generated intangible assets differently from intangible assets acquired in business combinations can potentially produce dramatically different financial reporting outcomes, which undermines the relevance and reliability (faithful representation) of general purpose financial reports.

11. Other commentators argue that a business combination is a unique circumstance that justifies a different treatment for assets acquired in a business combination from assets acquired in other ways. They note that under current standards not only are intangible assets acquired in a business combination treated differently from intangible assets acquired in other ways, but tangible assets, such as property, plant and equipment, acquired in a business combination are treated differently from internally generated tangible assets. They argue that internally generated intangible assets should be accounted for in the same way that internally generated tangible assets are accounted for. They acknowledge that this would more than likely result in the recognition of fewer internally generated intangible assets than if the principles in IFRS 3 are applied. However, they argue that it would conceivably result in the recognition of more internally generated intangible assets than are currently permitted to be recognised under IAS 38.

12. Another benefit of recognising more internally generated intangible assets than are currently permitted under IAS 38 is that it is consistent with the notion of accountability. Recognition of internally generated intangible assets enables an assessment of management's accountability for such assets. However, recognition is not a necessary means of enabling assessment of accountability. Accountability can arguably equally be assessed through disclosures in the notes to financial statements or by other means. Recognition is arguably more effective than mere disclosure in facilitating improved management practice, consistent with the business maxim "when you measure it, you manage it".

13. In relation to today's environment, it has been observed by Upton that:

> The importance of intangible assets is the distinguishing feature of the new economy. By and large, existing financial statements recognise those assets only when they are acquired from others. Accounting standard setters should develop a basis for the recognition and measurement of internally generated intangible assets. (page 59)[5]

In relation to the question of whether there is really a new economy, Upton observes, after commenting on page 1 that the economy of 2000 is fundamentally different from the economy of 1950 and earlier:

> Labels seldom help to solve problems. Labeling certainly doesn't help here. We may have a new economy, or our new tools may have given us an appreciation of factors that were always important. It doesn't matter which. The more important question is how to improve business and financial reporting. (page 9)

14. Chapters 2-5 explore whether there is a basis for treating internally generated intangible assets in the same way as intangible assets acquired in a business combination or internally generated tangible assets. This will lead to suggestions for recognition and measurement principles for the initial accounting for internally generated intangible assets that satisfy the *Framework*.

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[5] Upton W – 'Business and Financial Reporting, Challenges from the New Economy', Financial Accounting Series FASB 2001. (Referred to in this Paper as Upton (2001))

CHAPTER 2 – DEFINITION/IDENTIFICATION

INTRODUCTION

15. This Chapter considers the main issues relating to the initial identification of internally generated intangible assets in the context of the definitions of an asset and an intangible asset.

DEFINITIONS

16. The definitions and explanations of an asset and an intangible asset contained in the IASB's *Framework* and IFRS 3/IAS 38 are accepted for the purpose of this Paper.

17. Paragraph 49(a) of the *Framework* defines an asset as:

> a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

18. It is apparent from this definition that an asset may be intangible.[6] This is consistent with the fact that there is a definition of an intangible asset in paragraph 8 of IAS 38 (and repeated in Appendix A of IFRS 3):

> An intangible asset is an identifiable non-monetary asset without physical substance.

19. In explaining the meaning of 'identifiable' as it is used in the definition of an intangible asset, paragraph 12 of IAS 38 (and repeated in paragraph 46 of IFRS 3) further states that:

> An asset meets the identifiability criterion in the definition of an intangible asset when it:
>
> (a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or
>
> (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

[6] Indications to-date are that the definition of assets being developed under the IASB/FASB Conceptual Framework project also encompasses internally generated intangible assets. See, for instance, agenda paper 7 to the June 2006 IASB meeting "Conceptual Framework Elements: Asset Definition (iv) & Liability Definition (iii)".

20. IFRS 3 is accompanied by illustrative examples of items acquired in business combinations that meet the definition of an intangible asset. The examples are not exhaustive and do not form part of IFRS 3. However, they are instructive and notably broader than the types of intangible assets explicitly contemplated prior to the issue of IFRS 3. The examples are classified under the following five headings[7]:

    A Marketing-related intangible assets (eg trademarks #, trade names #, newspaper mastheads #, internet domain names #)

    B Customer-related intangible assets (eg customer lists *, order backlog #, customer contracts and the related customer relationships #, non-contractual customer relationships *)

    C Artistic-related intangible assets (eg plays #, literary works #, television programmes #)

    D Contract-based intangible assets (eg licensing agreements #, operating and broadcasting rights #, lease agreements #)

    E Technology-based intangible assets (eg patented technology #, computer software #, unpatented technology *, databases *, trade secrets #).

21. Even an intangible item that is held by an entity that, although the entity does not intend using but intends denying other entities' access to it, may satisfy the definition of an intangible asset. Paragraph A12 of SFAS 157 *Fair Value Measurements* (September 2006) explicitly addresses this circumstance and concludes that an asset exists (with not necessarily a value of zero). Accordingly, protection of a revenue stream from competition, for example, is an asset.

[7] In the Illustrative Examples that accompany IFRS 3, the IASB distinguishes intangible assets that arise from contractual or other legal rights (whether separable or not) and designate them with the symbol #, from intangible assets that do not arise from contractual or other legal rights but are separable and designate them with the symbol *. The symbol designations used in the Illustrative Examples in IFRS 3 are repeated in paragraph 20 of this Paper.

Identification of Internally Generated Intangible Assets

22. The definitions of an asset and an intangible asset, including the notion of identifiability, adopted by IFRS 3 do not distinguish between the manner in which the asset is acquired – separately (*[to be]* discussed in Section 2 of this Paper), as part of a business combination, or internally generated. Irrespective of the manner in which an intangible item is acquired, conceptually it satisfies the definition of an asset if it is a resource controlled by the enterprise as a result of a past event and from which future economic benefits are expected to flow.

23. A transaction in the nature of the incurrence of costs (even other than costs incurred in a business combination) may provide evidence of a past event as justification for identifying the existence of an intangible asset. However, it is evident from the definitions of an asset and an intangible asset adopted by IFRS 3 that it is not necessary for costs to be incurred in generating an asset. Even where costs are incurred it is not necessary to be able to attribute those costs to an asset to justify an asset's existence. The *Framework* also makes it clear that the incurrence of costs does not necessarily imply the creation of an asset. Paragraph 59 of the *Framework* states:

> There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained.

24. Upton (2001) states:

> Is there any rationale, based on the definition of an asset, why … items are assets when acquired in a business combination or other purchase and not assets when created internally?
>
> No. Genealogy is not an essential characteristic of an asset. If an item satisfies the definition of an asset, it matters not how the entity came to control the asset. A transaction with another entity – a purchase of individual items or a business combination – provides evidence that an asset may exist. However, it is not the only way that an entity can acquire or create assets. If it were, self-constructed tangible assets would never qualify for recognition. (page 70)

25. Although the manner by which an intangible item comes into existence is not a determinant of whether it meets the definition of an asset, it is necessary to determine which event would initiate its identification as an asset. In that regard, it is useful to consider the different ways in which internally generated intangible

assets may come into existence. For discussion purposes it is useful to distinguish two broad types of internally generated intangible assets, distinguished by the ways in which they are created:

(a) those created out of specific planned projects the primary purpose of which is to create the assets (referred to in this Paper as planned internally generated intangible assets); and

(b) other internally generated intangible assets, being those that arise from the day-to-day operations of a business (referred to in this Paper as unplanned internally generated intangible assets).[8]

26. Appendix B provides an analysis that confirms that both planned and unplanned internally generated intangible items may satisfy the definition of an asset.

27. Effectively, the distinction between planned and unplanned internally generated intangible assets is determined by the foresight of management and the manner in which management organises its intangible asset generating activities. Such a basis for distinguishing different types of internally generated intangible assets may be of concern if the two categories are subject to different accounting requirements. The identification of a planned internally generated intangible asset would be associated with the incurrence of costs reliably attributable to the asset. Some may be concerned that the identification of assets and their treatment would be determined merely by the quality of the cost attribution accounting system.

28. If it is decided that the two categories should be subject to different accounting requirements (an issue that is considered in Chapters 3 and 4), it would be necessary to ensure that the distinction between the two categories is clear. Discussing the two categories separately is not intended to pre-empt the question of whether they should be treated differently for accounting purposes.

[8] These categories, although expressed slightly differently, are also identified by Upton (2001). In addition, Upton (page 70) identifies a third category – those that exist only by virtue of their relation to some other asset or liability, such as value of insurance-in-force. For the purposes of this Paper, this category is subsumed into the unplanned internally generated intangible assets category.

Planned Internally Generated Intangible Assets

29. Planned internally generated intangible assets include the types of intangible assets that IAS 38 contemplates as arising from a research phase or development phase of an internal project. However, the nature of planned internally generated intangible assets is broader than research and development, and may arise earlier than when IAS 38 contemplates them being recognised. For example, there may be a specific planned project to develop a brand and costs can be reliably attributed as the plan is implemented. Compared with research and development projects, it may be more difficult to identify when a brand moves from its work in process phase to its completed phase, but in concept the same principles apply.

30. A completed project, and even an abandoned project, may yield knowledge that, if kept secret, satisfies the definition of an asset. In this Paper, a successful project means that the future economic benefits expected to be derived from the new knowledge exceed the costs of acquiring it. Unsuccessful projects include those that, although they are expected to provide future economic benefits from the new knowledge they yield, the benefits do not exceed the costs of acquiring the knowledge. For example, pursuing a line of enquiry only to find that it is a 'dead-end' provides knowledge that it is a dead-end, which is of some benefit but presumably the foreseeable benefit does not exceed the cost of acquiring the knowledge.

31. For the purpose of Chapters 1-5, 'initial' accounting for a planned internally generated intangible asset commences at the start of implementing the plan and occurs up to completion or abandonment of the related project. A question arises as to whether knowledge must have been acquired (that is, whether a plan's success or failure must be known) before an asset is identified or whether it is appropriate to identify an asset (an in-process asset) in the process of, for example, pursuing knowledge that is to be kept secret (a finished asset). The nature of in-process research and development, for example, implies that success or failure may not yet be known. Despite this, IFRS 3 anticipates it being identified as an asset acquired in a business combination. Consistent with this, an item that arises during the process of developing a planned internally generated

intangible asset is capable of being an (interim) asset in its own right.[9] In contrast, IAS 38 only contemplates the recognition of an asset when, and only when, its technical and commercial feasibility of completion can be demonstrated by the entity. This matter is further discussed in Chapter 3 of this Paper in the context of recognition.

32. Given the dynamic nature of many specific planned projects, plans may be modified. This may cause the subject asset or assets to change. If, for example, a plan is split into two separate projects, an issue may arise as to how to allocate previously incurred costs to the split projects. This is a one-to-many problem not unique to intangible assets and therefore does not present unique or insurmountable problems, and is more pertinent to the initial measurement issue rather than the initial identification issue.

Unplanned Internally Generated Intangible Assets

33. Although unplanned internally generated intangible assets may have observable activities associated with them, they differ from planned internally generated intangible assets in that the observable activities are not undertaken as part of a specific planned project.

34. The identification of unplanned internally generated intangible assets might coincide with the incurrence of costs, but even if it does, those costs would not be reliably attributable to the asset due to the absence of a specific planned project. Examples are internally generated brands, mastheads, publishing titles and customer lists that have not been, or are not being, created out of specific planned projects. Under the current requirements in IAS 38 such assets are acknowledged as being assets but are not recognised. For example, paragraph 63 of IAS 38 states:

> Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

[9] Similarly, extractive activities accounting under the 'area of interest' approach anticipates the existence of an asset as exploration takes place. The 'area of interest' approach is prescribed in Australian Accounting Standard AASB 6 *Exploration for and Evaluation of Mineral Resources*.

35. There may not be a specific event that causes an entity to become aware that an identifiable internally generated intangible asset exists. Therefore, it may be necessary at each reporting date to search for unplanned internally generated intangible assets that may have emerged since the previous reporting date. A technique for undertaking such an exercise is considered in paragraphs 40-44 of this Paper.

Descriptors for Individual Internally Generated Intangible Assets

36. In considering whether a planned or unplanned internally generated intangible item satisfies the definition of an asset, it is necessary to circumscribe the item, and adopt a descriptor that depicts the item's economic phenomenon. This then identifies the unit of account. For planned internally generated intangible assets, the unit of account may be determined by the project, having regard to the principles in paragraphs 37 and 38 of this Paper. There may be an interim unit of account in the nature of an in-process asset until the ultimate unit of account is identifiable following completion or abandonment of the project. For unplanned internally generated intangible assets, in the absence of an identifiable project, the unit of account may also be determined having regard to the principles in paragraphs 37 and 38 of this Paper.

37. The description used for a tangible asset such as land may include an intangible component. For example, the (intangible) view from a block of land is inextricably linked to the land and in practice it is not separated nor typically explicitly acknowledged for financial reporting purposes. On the other hand, other intangible attributes of land may be separately recognised, such as 'development rights' granted by a Council on the land, or 'specific use rights' granted for a building (eg to operate a casino). It is generally understood that the descriptor 'land' includes non-physical attributes such as the view from the land. The descriptor conveys the nature of the asset (eg land), and measurement incorporates possible additional attributes (eg coastal view).

38. Similar to land, the descriptor ascribed to an internally generated intangible asset should be meaningful in its commonly understood way, even though it may include a range of inextricably linked intangible attributes. Examples of this

specifically related to intangible assets are noted in paragraphs 36 and 37 of IAS 38. One example contemplated in IAS 38 is that the descriptor 'brand' may comprise a group of complementary assets such as a trademark and its related trade name, formulas, recipes and technological expertise. The description that is appropriate to be adopted for an item can only be considered on an item-by-item/asset-by-asset basis, because of the different ways in which entities structure and manage their projects and the different objectives they aim to achieve. Issues relating to descriptors suitable for internally generated intangible assets are discussed further in Chapter 5 of this Paper.

How to Identify the Internally Generated Intangible Assets of an Entity

39. In the absence of a business combination or other transaction, a question arises as to how to identify the internally generated intangible assets of an entity. This question is related to the question of recognition as it would be onerous to require an entity to identify internally generated intangible assets if the IASB does not intend that they be recognised. However, for the purpose of this Chapter, the following considers a technique for identifying an entity's internally generated intangible assets without regard to recognition consequences. Chapter 3 then considers the technique in the context of recognition.

A technique based on a hypothetical business combination

40. Identification of all of the intangible assets within an entity could be achieved through a technique based on a hypothetical business combination whereby the entity is assumed to be an acquiree as at the reporting date. This 'top-down' approach is a mechanism for ensuring that the assets of an entity are identified from an holistic perspective. A more piecemeal 'bottom-up' approach to identifying assets runs the risk of overlooking some assets.

41. As reported in an article by Britton Manasco 'Dow Chemical Capitalizes on Intellectual Assets',[10] Dow Chemical undertook an exercise for internal management purposes that included the identification of 'patents' and was planning to undertake a similar exercise for 'know-how'. It is apparent from the

[10] Published in the March 1997 issue of 'Knowledge Inc'.

work of Gordon Pretash and his team at Dow Chemical that the exercise was demanding but provided valuable information. Similarly, an exercise undertaken to identify intangible assets acquired in a business combination for external financial reporting purposes would be demanding but provides valuable information. Arguably the exercise of identifying internally generated intangible assets is less demanding than the exercise of identifying intangible assets acquired in a business combination, as noted in the following paragraph.

42. There are different circumstances in each business combination. In a 'friendly' business combination a thorough due diligence is typically possible. In a 'hostile' business combination, there may be very little opportunity for due diligence. Presumably an entity knows more about its existing internally generated intangible assets than the intangible assets it acquires in a business combination, particularly if the business combination is hostile, because it has been involved in their creation.

43. A technique based on a hypothetical business combination has similarities with aspects of step two of the two-step approach for impairment testing goodwill that was proposed as part of Phase I of the IASB Business Combinations project (ED 3 *Business Combinations*, published in December 2002 together with Exposure Draft of Proposed Amendments to IAS 36, *Impairment of Assets*, and IAS 38 *Intangible Assets*). That step involved the determination of the implied value of goodwill, which in turn was effectively determined using a hypothetical business combination technique. As indicated in paragraphs BC165 to BC170 accompanying IAS 36, the IASB rejected the approach for the purpose of impairment testing goodwill, including on cost-benefit grounds. This was despite the proposed inclusion of some relief to the detailed calculations that might otherwise be required, by accepting for impairment testing purposes the most recent detailed calculation made in a preceding reporting period of the recoverable amount of a cash-generating unit to which goodwill has been allocated for that unit in the current period, provided specified criteria are met (see paragraph 96 of the Exposure Draft of Proposed Amendments to IAS 36, *Impairment of Assets*, and IAS 38, *Intangible Assets*). For the purpose of this Chapter, it is sufficient to note that a technique based on a hypothetical business combination could be

adopted for the purposes of initially identifying the existence of internally generated intangible assets. Whether it should be extended to provide a context for the initial recognition and measurement of the assets is considered in Chapters 3 and 4 respectively. Arguably, the resulting benefits exceed those that would be derived from the technique if it were to be used only for the purpose of impairment testing goodwill.

44. It is acknowledged that applying a technique based on a hypothetical business combination may be difficult and costly the first time it is adopted. However, it is expected that once a system for identifying internally generated intangible assets is in place, the ongoing costs and efforts will be significantly less than the initial costs and efforts. Furthermore, if the IASB decides not to require the recognition of all such assets, it may be possible to find less onerous techniques for identifying fewer internally generated intangible assets, effectively using the identification process as a recognition filter. These alternative techniques are considered in the context of recognition in Chapter 3.

INTERVIEWEES' PERSPECTIVES ON THE IDENTIFICATION OF INTANGIBLE ASSETS

45. By virtue of their roles as accountants, auditors and professional advisors, those from large accounting firms who were interviewed for the purpose of this project noted their experiences in identifying a broad range of internally generated intangible assets. The main categories of internally generated intangible assets encountered prior to the introduction of IFRS 3/IAS 38 by those from large accounting firms interviewed included brand names and related trademarks, mastheads, patents, technological assets, customer relations and client lists, distribution/franchising agreements, management rights and research and development. A number of interviewees also mentioned 'intellectual property', which can be regarded to some extent as an umbrella term for a range of intangible assets. The financial report preparers interviewed from consumer product corporations identified internally generated brand names and associated intangible assets, including distribution/franchising agreements and customer mailing lists as the main types of internally generated intangible assets about which they had experience. These preparers also noted a number of other types of

internally generated intangible assets their corporations had identified (and recognised) prior to the introduction of IFRS 3/IAS 38, including software development costs, intellectual property and marketing and advertising costs.

46. Those interviewed from financial services corporations indicated that they had not normally identified (and recognised) internally generated intangible assets, particularly with respect to the banking side of their businesses, mainly due to the requirements imposed upon them by prudential regulations.[11] Nevertheless, those from financial services corporations noted that on occasions they had capitalised software development costs, but only when the cost of the specific project exceeded a fixed monetary or materiality threshold. One of those from a financial services corporation also noted that the carrying value of its life insurance liabilities incorporated a value for margins related to in-force business, including the value of new business from its existing client base. One of those from a telecommunication and broadcasting corporation noted that the main category of internally generated intangible asset it had identified (and recognised) in the past was software development costs. The other telecommunication and broadcasting corporation advised that in the past it had generally resisted identifying (and recognising) internally generated intangible assets. **[Remainder of paragraph omitted from observer notes]**

[11] Approved deposit-taking institutions (ADI) in Australia are required to retain a minimum level of risk-based capital to support the risks associated with their activities. To ensure that they have an adequate level of capital, ADIs are required to maintain, at a minimum, a risk-based capital ratio of 8 per cent at all times. An ADI's risk-based capital ratio is based upon the accounting numbers reported in its audited general purpose financial reports and is calculated by dividing the ADI's eligible capital base by its total risk-weighted on-balance sheet items (such as loans, deposits and fixed assets) and off-balance sheet exposures (such as commercial guarantees and other commitments). At least half of the ADI's eligible capital base (4%) must comprise Tier 1 capital (including paid-up ordinary shares, general reserves, retained earnings and current year's earnings net of expected dividends and tax expenses). The remaining (Tier 2) capital comprises items such as revaluation reserves of premises and securities, general provisions for doubtful debts, approved cumulative irredeemable preference shares, approved limited life subordinated debt and approved limited life redeemable preference shares. In calculating an ADI's capital base, intangible assets, including capitalised expenditures and purchased goodwill, are excluded from the risk-weighted exposures and, if reported in the ADI's balance sheet, are deducted from its Tier 1 capital. Consequently, for prudential capital purposes, all expenditures on intangible items reported in the financial statements of ADIs will be treated as if they had been expensed to the ADI's profit or loss for the period (see Australian Prudential Regulation Authority (APRA) Prudential Standard APS 110 – *Capital Adequacy* (July 2003), APRA Prudential Standard APS 111 – *Capital Adequacy: Measurement of Capital* (December 2003) and APRA Guidance Note AGN 110.4 – *Risk-based Capital Adequacy Framework* (July 2003)).

47. All of the large accounting firms interviewed noted that the presence of economic benefits that could be directly attributed to an intangible item was critical to its identification as an asset.[12] In many cases, identifiable separable cash flows directly attributable to an intangible item were regarded as sufficient to indicate the existence of economic benefits. However, other factors were also regarded as persuasive. For instance, if the economic benefits attributable to an intangible asset are not separately identifiable from the benefits generated by the larger business unit to which the internally generated intangible asset belongs (a cash generating unit/unit of account issue), but it is reasonable to assume that the productivity of the business unit would be diminished by removing the intangible asset, this was sufficient to indicate the existence of economic benefits. Other factors identified by interviewees as suggesting the existence of an intangible asset included the presence of contractual or other legal rights or the likely prospect of being able to sell the intangible asset to an unrelated third party (which suggests that control and future economic benefits are satisfied and the separability criterion in the definition of identifiability is met).

48. Like those from large accounting firms, the preparers from consumer product corporations indicated that the presence of economic benefits directly attributable to an internally generated intangible item was critical to its identification as an asset. Consistent with their marketing focus, those from consumer product corporations emphasised the role intangible assets play in their operations in generating earnings. In particular, those from consumer product corporations noted the capacity of brand names to provide assurance to their owners of demand for the related products, indicated by a positive relationship between marketing expenditure and product demand. Those from consumer product corporations also noted that the existence of a positive deprival or resale value for an internally generated intangible item was taken to indicate the presence of future economic benefits.

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[12] Consistent with recent decisions of the IASB (for example, in relation to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* redeliberations relating to the phrase ‘expected to’ in the definition of a liability), the presence of expected future cash flows as the basis for the existence of an asset is not essential. Rather it is the present right that is the essence of an asset, not the expectation of future economic benefits.

49. Other comments from interviewees addressed the control aspect of the definition of an asset. In particular, interviewees from large accounting firms and the three from consumer product corporations indicated that, consistent with the notion of identifiability in IAS 38, legal control in the form of a registered trademark or contract was sufficient to suggest that future economic benefits were likely to flow to the entity and therefore that an asset exists. Of the interviewees who indicated that their corporations identified (and recognised) internally generated software as an intangible asset prior to the introduction of IAS 38,[13] some confirmed that they had capitalised software development expenditures once they exceeded a pre-determined dollar or materiality threshold. Moreover, all of the entities that indicated they capitalised software development expenditures confirmed that they incurred the expenditures for the purpose of developing software for internal administrative purposes. This appears to be consistent with, for example, AICPA AcSEC SOP 98-1 *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (March 1998). Taken together, these factors suggest that, in the absence of legal control, the future economic benefits associated with an internally generated intangible asset are arguably more likely to be controlled by an entity when the asset is created out of a specific planned project and is expected to provide benefits to the entity in the form of decreased outflows (as opposed to increased inflows) of economic benefits in the future. While an entity might be able to exclude competitors from capturing some or all of the benefits associated with improved administration systems by maintaining secrecy around its development, the same cannot be said for design, construction and assembly improvements in products sold in the market place, unless they can be protected in some way.

CONCLUSION

50. This Chapter concludes that the manner by which an intangible item comes into existence is not relevant to the determination of whether the item can be identified as an asset. Therefore, items of the same nature, irrespective of whether they are acquired in a business combination or internally generated (planned or unplanned), should be analysed in the same way for the purpose of determining

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[13] Both of the financial services corporations, one of the consumer product corporations and one of

whether they are assets. The principles and guidance for identifying the existence of and describing an intangible asset acquired in a business combination specified in IFRS 3 and IAS 38 should be adopted for assessing whether internally generated intangible assets exist. On that basis a technique based on a hypothetical business combination is a suitable technique for identifying internally generated intangible assets.

Implications for Current Requirements

51. This conclusion is consistent with IAS 38 because IAS 38 adopts the definitions of asset and intangible asset consistent with IFRS 3, even for internally generated intangible assets. However, IAS 38 has limited guidance on the identification of internally generated intangible assets. If the view in paragraph 50 of this Paper is adopted, the current guidance for identifying intangible assets acquired in a business combination in IFRS 3/IAS 38 should be adopted for the identification of internally generated intangible assets.

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the telecommunication and broadcasting corporations.

CHAPTER 3 – RECOGNITION

INTRODUCTION

52. This Chapter considers the main issues relating to the recognition criteria appropriate for items that satisfy the definition of intangible assets and are identified as internally generated intangible assets in accordance with the conclusion in Chapter 2.

53. Currently IAS 38 uses classifications of 'research', 'development' and 'brands, mastheads, publishing titles, customer lists and items similar in substance' to prescribe specific recognition requirements that are more restrictive than the general asset recognition criteria in the *Framework*. IAS 38 prohibits recognition of assets arising from 'research' and 'brands, mastheads, publishing titles, customer lists and items similar in substance' and requires the recognition of assets arising from 'development' only in certain circumstances. Paragraph 51 of IAS 38 provides the rationale for adopting the more restrictive specific recognition criteria:

> It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in:
> (a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and
> (b) determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations …

54. From the *Framework* perspective, in circumstances where an internally generated intangible item satisfies the definition of an asset and is identified as an intangible asset, its recognition will depend on whether the asset recognition criteria specified in the *Framework* are met. Those criteria apply to both planned and unplanned internally generated intangible assets.

55. Paragraph 83 of the *Framework* states:

> An item that meets the definition of an element should be recognised if:
> (a) it is probable that any future economic benefit associated with the item will flow to … the enterprise; and
> (b) the item has a cost or value that can be measured with reliability.

56. Because the *Framework* does not express a preference for cost or value, it is useful to consider these recognition criteria in the context of both a cost-based model and a valuation-based model. For the purpose of this Paper, a cost-based model is one in which the emphasis is on accounting for the consequences of costs (that is, historical cost) incurred by the reporting entity. A valuation-based model is one in which the emphasis is on accounting for value, and changes in value, irrespective of whether or not that value arises from an attributable transaction (incurrence of cost). Although the *Framework* does not specify the value measurement attribute, given the adoption of fair value in a number of recent IASB standards and its prominence in a range of current projects, this Paper focuses on fair value. Consistent with the *Framework*, this Paper does not express a preference for the model to be adopted in the context of the recognition criteria. However, Chapter 4 expresses a standards-level preference from a measurement perspective.

57. Paragraph 21(b) of IAS 38 relating to initial recognition of internally generated intangible assets only refers to cost (as does IAS 16 in relation to initial recognition of internally generated property, plant and equipment) and is therefore consistent with a cost-based model. Paragraph 37(c) of IFRS 3 relating to initial recognition of intangible assets acquired in a business combination only refers to fair value and is arguably therefore consistent with a valuation-based model, as discussed in the following paragraph.

58. The cost to the acquirer of a particular asset acquired in a business combination is not directly available. Accordingly, IFRS 3 does not contemplate cost as such as a measurement basis in specifying recognition criteria. However, paragraph 33 of IAS 38 states that if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. Therefore, some argue, paragraph 33 of IAS 38 implies that the IASB's measurement preference is cost over fair value, and fair value is only used in the absence of cost and as an expedient way of accounting for the transaction. The implication that the fair value of assets acquired in business combinations is a surrogate for cost is carried over from the previous version of IAS 38 (issued in 1998). Whether it reflects the current thinking of the IASB will be determined in the context of the

conceptual-level IASB/FASB Measurement project. Arguably, based on recent IASB decisions in relation to the Business Combinations Phase II project, the fair value of intangible assets acquired in a business combination is not perceived to be a surrogate for cost, but is fair value in its own right.

59. In relation to a planned internally generated intangible asset in a cost-based model, the recognition criteria will result in attributable costs being initially capitalised from commencement of implementing the plan. Capitalisation of costs may be a mechanism for initially recognising planned internally generated intangible assets even under a valuation-based model. In a valuation-based model, for bookkeeping purposes, the costs may be capitalised as they are incurred and the capitalised amount subsequently adjusted up or down to fair value at reporting date. In these circumstances cost capitalisation is a bookkeeping exercise rather than an asset measurement exercise, and as such will affect the gross amounts recognised in the income statement or other non-owner movements in equity and the description of those amounts (for example, impairment of capitalised research and development costs rather than research and development expenses).

60. While the occurrence of a cost may be used as the basis for recording an accounting entry in a valuation-based model, it is not necessary. Therefore, unplanned internally generated intangible assets are candidates for recognition in a valuation-based model, but not in a cost-based model.

61. Where the asset recognition criteria are not met, all costs attributed to the activity giving rise to the asset should be immediately expensed, and no asset should be recognised.

62. Whether or not an internally generated intangible asset that fails the asset recognition criteria should be subject to disclosure requirements is addressed in Chapter 5.

RECOGNITION UNDER A COST-BASED MODEL

63. A cost-based model would be more likely to recognise an (internally generated intangible) asset where a transaction occurs, such as a business combination or the

incurrence of costs in undertaking a specific planned project (planned internally generated intangible assets), than if no transaction occurs. Therefore, as noted in paragraph 60, unplanned internally generated intangible assets would not be recognised in a pure cost-based model.

Probable Future Economic Benefits Recognition Criterion[14]

64. Under a cost-based model, the recognition of capitalised costs associated with a planned internally generated intangible asset would only be justified where future economic benefits are probable. This would be the case for successful planned projects. It may also be the case for in-process and even unsuccessful (see paragraph 30) planned projects. Despite the 'probable future economic benefits' recognition criterion arguably being a higher hurdle than 'expectation of future economic benefits' contained in the definition of an asset in paragraph 49(a) of the *Framework*, like the definition (see paragraphs B3-B8 of Appendix B of this Paper), the recognition criterion does not specify a requirement for positive net future economic benefits. Therefore, it is conceivable that the recognition criterion could be met even where it transpires that negative net future economic benefits are probable – so long as positive gross future economic benefits are probable. Circumstances where gross outflows (attributable costs) exceed gross inflows should be addressed through measurement/impairment rather than through recognition (or definition), which is *[to be]* discussed in Section 3.

Reliable Measurement Recognition Criterion

65. Under a cost-based model, consistent with the *Framework*, internally generated intangible assets would be initially measured at cost where cost is reliably measurable. Given the interrelatedness between the reliable measurement recognition criterion and the issues that arise in relation to the initial measurement of internally generated intangible assets at cost, the discussion of whether the cost of internally generated intangible assets can be reliably measured is provided in Chapter 4.

[14] Given the direction of the IASB/FASB Conceptual Framework project, the 'probable future economic benefits' recognition criterion may be removed from the *Framework*. Until then, this Paper discusses it on the assumption it continues to exist.

Are Recognition Criteria More Restrictive than the Framework Recognition Criteria Warranted for Internally Generated Intangible Assets that can be Reliably Measured at Cost?

66. Some argue that adoption of the *Framework* asset recognition criteria under a cost-based model would result in the recognition of too many internally generated intangible assets, even though they are restricted to planned internally generated intangible assets. They believe that the current, more restrictive, recognition criteria in IAS 38 are appropriate. Some even argue that the IAS 38 criteria should be more restrictive.

67. Research costs are generally expensed as incurred under current IASB and national requirements. This is consistent with the view held by some that research costs, by their nature, are too remote from their ultimate potential outcome to be regarded as costs that give rise to an asset.

68. Some jurisdictions (US, Germany, Japan) also require development costs to be expensed as incurred. The Basis for Conclusions accompanying SFAS 2 *Accounting for Research and Development Costs* (October 1974) identifies a number of reasons for expensing development (and research) costs. The reasons include uncertainty of future benefits, a lack of causal relationship between expenditures and benefits, an inability to determine a reliable measurement of the future economic benefits, and the failure of capitalisation to provide useful information to users.

69. In contrast, the IASB and certain national standard-setters require development costs to be capitalised if specific criteria are met (including an entity being able to demonstrate technical and commercial feasibility of completion). In particular, IAS 38 distinguishes between different types of assets arising from development. Only where an entity can demonstrate all of the following in relation to an asset arising from development would it be recognised (paragraph 57 of IAS 38):

    (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;
    (b) its intention to complete the intangible asset and use or sell it;
    (c) its ability to use or sell the intangible asset;
    (d) 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;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Although many of the factors listed in IAS 38 are indicative of probable future economic benefits, the emphasis on completion does not acknowledge that an ‘unsuccessful’ project may also have probable future economic benefits. It also does not acknowledge that an asset may exist prior to the specific recognition criteria being met, resulting in only partial recognition of the asset. A rationale used for the capitalisation of development costs compared with research costs is that development costs can be more readily associated with an identifiable project/asset. There is no conceptual basis for treating assets arising from research differently from assets arising from development, nor treating assets arising from research and development differently from other planned internally generated intangible assets (and indeed from internally generated tangible assets as per IAS 16).

70. The reluctance to recognise an intangible asset until technical and commercial feasibility of completion can be demonstrated reflects a concern that the intangible nature of the asset means that it warrants different recognition criteria than a tangible asset. There is no conceptual basis for such a view. However, arguably, embedding the notion of ‘identifiability’ in the definition of intangible assets perpetuates the perception that intangible assets are fundamentally different from tangible assets. This project accepts the explicit characteristic of identifiability for intangible assets, noting that the same characteristic applies to a tangible asset but it does not need to be stated explicitly given the tangible nature of the asset. The identification and recognition of intangible assets acquired in a business combination is not predicated on the additional recognition criteria specified in IAS 38 for assets arising from development activities. Accordingly, an appropriate substitute for the ‘able to demonstrate technical and commercial feasibility of completion’ criterion in IAS 38 is ‘the existence of evidence of a plan that is being implemented’ criterion. Such a recognition criterion is consistent with the notion of ‘identifiability’ in a cost-based model.

Conclusion

71. *This Chapter concludes that only planned internally generated intangible assets should be contemplated for recognition under a pure cost-based model. They do not warrant specific recognition criteria other than specification of the meaning of 'planned'. Accordingly, all planned internally generated intangible assets that satisfy the Framework recognition criteria of 'probable future economic benefits' and 'reliable measurement of cost' should be recognised.*

Implications for Current Requirements

72. The main difference between IAS 38 and what this Chapter advocates under a cost-based model is that:

    (a) IAS 38 distinguishes between research and development and only allows some assets arising from development to be recognised at a point in time later than that advocated in this Paper; and

    (b) this Chapter distinguishes between planned and unplanned internally generated intangible assets and advocates, under a cost-based model, recognition of all planned internally generated intangible assets, even if they do not arise from research or development.

    Consequently, if the conclusion in paragraph 71 above is accepted, the specific recognition requirements in paragraphs 51-61 of IAS 38 would be replaced by guidance on identification of planned internally generated intangible assets. However, it would not be necessary to amend the general recognition criteria specified in paragraph 21 of IAS 38 because, in a cost-based model, reliable measurement of cost is an appropriate recognition criterion.

RECOGNITION UNDER A VALUATION-BASED MODEL

73. A valuation-based model is not dependent on there being a specific planned project with attributable costs and, therefore, may more readily result in the recognition of an asset (even an unplanned internally generated intangible asset) in the absence of an attributable transaction if some other event has occurred.

Probable Future Economic Benefits Recognition Criterion

74. Although the 'probable future economic benefits' recognition criterion may be relevant where cost is adopted as a measurement basis, it is evident from the conclusions drawn in developing IFRS 3 that it is not relevant where assets are initially measured at fair value. In particular, IFRS 3 does not specify probable future economic benefits as an initial recognition criterion for intangible assets acquired in a business combination. Instead, paragraph 37 of IFRS 3 states:

> The acquirer shall recognise separately the acquiree's identifiable assets … at the acquisition date only if they satisfy the following criteria at that date: …
> (c) in the case of an intangible asset … its fair value can be measured reliably.

75. Paragraph BC96 that accompanies IFRS 3 (and paragraph 33 of IAS 38) explains that the fair value of an intangible asset reflects market expectations about the probability that the future economic benefits associated with the intangible asset will flow to the acquirer and, therefore, the effect of probability is reflected in the fair value measurement of an intangible asset.[15] Such a rationale is applicable for both intangible assets acquired in a business combination and internally generated intangible assets (whether planned or unplanned).

Reliable Measurement Recognition Criterion

76. In developing IFRS 3 the IASB contemplated not even specifying reliable measurement of fair value as a recognition criterion for intangible assets acquired in business combinations. Indeed the IASB is again contemplating such an approach in its Business Combinations Phase II project on the basis that identifiability implies measurability. In developing IFRS 3's requirement to measure intangible assets acquired in business combinations at fair value, as indicated in paragraph BC95 that accompanies IFRS 3, the IASB originally proposed that the recognition criteria for intangible assets acquired in business combinations would, with the exception of an assembled workforce, always be

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[15] The IASB observed that this rationale highlights a general inconsistency between the recognition criteria for assets and liabilities in the *Framework* and the fair value measurements required in, for example, business combinations. Paragraph BC96 goes on to say: "However, the Board concluded that the role of probability as a criterion for recognition in the *Framework* should be considered more generally as part of a forthcoming Concepts project." See also footnote 14 (to the heading above paragraph 64) of this Paper.

satisfied. After considering respondents' comments, the IASB decided to proceed with the proposal that the probability recognition criterion is always satisfied (see paragraph 74 of this Paper) but not proceed with the reliable measurement non-rebuttable presumption. The debate surrounding this issue is reflected in paragraphs BC97-BC106 accompanying IFRS 3 and is reproduced in Appendix C of this Paper.

77. Although the IASB did not proceed with the fair value reliable measurement non-rebuttable presumption, paragraph 35 of IAS 38 makes the following assertions:

    (a) "The fair value of intangible assets acquired in business combinations can **normally** be measured with sufficient reliability to be recognised separately from goodwill" (emphasis added); and

    (b) "If an intangible asset acquired in a business combination has a finite useful life, there is a **rebuttable presumption** that its fair value can be measured reliably" (emphasis added).

78. Given the interrelatedness between the reliable measurement recognition criterion and the issues that arise in relation to the initial measurement of internally generated intangible assets, the discussion of whether the fair value of internally generated intangible assets can be reliably measured is provided in Chapter 4.

Are Recognition Criteria More Restrictive than the Framework Recognition Criteria Warranted for Internally Generated Intangible Assets that can be Reliably Measured at Fair Value?

79. Some argue that adoption of the *Framework* asset recognition criteria would result in the recognition of too many internally generated intangible assets under a valuation-based model. As indicated in paragraph 11 of this Paper, some argue strongly that business combinations are unique situations and that the principles developed for business combinations should not be imposed on other circumstances. In particular, they argue that the principles in IFRS 3 should not be applied to the recognition of internally generated intangible assets. They argue that, unlike many internally generated intangible assets, IFRS 3 deals with circumstances where there is a transaction (being a business combination)

providing a particular context to the recognition of intangible assets. The extent of due diligence typically associated with a business combination particularly provides a cost-effective context for recognising intangible assets. Also, it is evident from paragraph BC101 that accompanies IFRS 3 that a primary rationale for the IASB adopting the approach in IFRS 3 to recognising intangible assets in a business combination is to minimise the risk of goodwill arising in a business combination otherwise including value attributable to intangible assets.[16] Such a rationale is not relevant to the recognition of internally generated intangible assets because internally generated goodwill (consideration of which is outside the scope of this project) is not recognised. Typically under IFRS 3 the recognition of an intangible asset acquired in a business combination would not increase net assets. It merely substitutes one asset (an intangible asset) for what would otherwise be recognised as another asset (goodwill). Therefore, on the assumption that it is inappropriate to recognise internally generated goodwill and that it is not the primary purpose of a balance sheet to provide a business valuation,[17] the risks of undermining the quality of financial statements by overstating net assets are arguably higher if an internally generated intangible asset is recognised. Some conclude that these factors provide a conceptual justification for recognising intangible assets acquired in business combinations and not necessarily recognising the same types of intangible assets that are internally generated.

80. Although IFRS 3 effectively characterises the recognition of intangible assets in a business combination as part of the process of allocating the cost of the business combination (see paragraph 36 of IFRS 3),[18] in fact IFRS 3 requirements mean that the cost does not provide a cap for the purposes of allocation – it merely

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16 BC 101 of IFRS 3 states: "… the Board remained of the view that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill, particularly given the Board's decision to regard goodwill as an indefinite-lived asset that is not amortised…"

17 Paragraph OB20 of the IASB/FASB Preliminary Views Paper states: "… financial reports are not designed to show the value of an entity".

18 The Business Combinations Phase II project is moving away from the view that identification (and measurement) of intangible assets acquired in a business combination is part of a cost allocation exercise. Instead it is more explicitly and directly requiring assets acquired to be identified, irrespective of the cost of the business combination (see paragraph 28 of IASB Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations* (June 2005) compared with paragraph 36 of IFRS 3).

provides a 'reality check'. Paragraph 56 of IFRS 3 contemplates that the net fair value of the identifiable assets (including intangible assets), liabilities and contingent liabilities recognised in a business combination may exceed the cost of the business combination.[19] If this situation arises, IFRS 3 requires a reassessment of any excess to confirm that the excess is valid and the recognition of any remaining excess immediately in profit or loss. Because the IFRS 3 principles for recognising intangible assets are not limited by the cost of a business combination, conceptually they could be applied for the purpose of recognising internally generated intangible assets.

81. Some also argue that there are practical reasons for not recognising internally generated intangible assets despite recognising the same types of intangible assets acquired in a business combination. They argue that, given the way IFRS 3 is implemented in practice, it would not be appropriate, or indeed in some cases possible, to adopt a similar approach for internally generated intangible assets. This is particularly the case where practice has continued to treat the recognition of assets and liabilities acquired in a business combination as a cost allocation exercise and to recognise and measure intangible assets by taking into accounting an acquirer's intentions. Although these latter arguments need to be acknowledged as potential impediments to the recognition of internally generated intangible assets, they can be rejected on conceptual grounds on the basis that they are in direct conflict with the requirements in IFRS 3. Furthermore, the failure to fully adopt the requirements in IFRS 3 may represent a transitory response by individual practitioners to the relatively new accounting requirements. Consequently, as practitioners become more familiar with applying the requirements in IFRS 3, resistance to recognising internally generated intangible assets on the basis of the principles in IFRS 3 may reduce over time.

82. A technique contemplated in Chapter 2 for identifying internally generated intangible assets is a technique based on a hypothetical business combination. Such a technique is criticised by some on cost-benefit grounds. To address concerns that the hypothetical business combination technique is too costly, some

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[19] The joint IASB/FASB project update (updated 30 June 2006) for "Business Combinations: Applying the Acquisition Method" on the FASB website notes that it is only in rare circumstances that a business combination is not an exchange of equal value.

advocate more pragmatic techniques that effectively use asset identification techniques as recognition filters. These are considered in paragraphs 83-86.

Recognise an Internally Generated Intangible Asset only where there is an Indicator that it Exists

83. A technique for identifying the existence of internally generated intangible assets, other than a technique based on a hypothetical business combination, is to adopt an indicator approach whereby only where there is an indication that an asset exists as at reporting date should it be considered for recognition. An example of an indicator might be a documented plan to develop a particular intangible asset. The existence of the plan would cause management to consider whether an internally generated intangible asset exists. Another indicator might be a documented management strategy to manage an asset that, although not developed following an explicit plan, exists at reporting date and has been identified by management as worthy of its attention. This is similar to the approach taken in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, whereby an asset cannot be classified as held for sale unless the appropriate level of management is committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan has been initiated (see paragraph 8 of IFRS 5).

84. An advantage of this technique is that it is less costly than a technique based on a hypothetical business combination technique. A disadvantage is that it risks the non-recognition of certain internally generated intangible assets that satisfy the *Framework's* asset recognition criteria. Another disadvantage is that identification/recognition depends on the actions of management, resulting in loss of comparability between entities.

Recognise an Internally Generated Intangible Asset only where it arises from a Plan

85. Another technique for identifying internally generated intangible assets to be considered for recognition would be to only identify assets where they are in the process of being developed or have arisen from the completion or abandonment of a specific plan.

86. An advantage of this technique is that it is even less costly than the indicator technique described in paragraph 83. Also, some argue that it has the advantage that it results in the recognition of the same internally generated intangible assets that would be recognised under a cost-based model (albeit measured differently). Furthermore, it is consistent with the requirements in IAS 16 for the recognition of internally generated property, plant and equipment. However, it is arguably more effective in the context of tangible assets because such assets tend not to emerge from unplanned activities and when they do they are obvious and therefore not costly to identify. Therefore, a major disadvantage of this technique is that it fails to contemplate for recognition any unplanned internally generated intangible assets. The challenge for a standard-setter would be to define the distinction between planned and unplanned internally generated intangible assets in a robust way.

Conclusion

87. The conceptual and practical challenges of identifying intangible assets for recognition purposes are overcome in a business combination. In concept, if a valuation-based model is adopted, there is no reason to treat internally generated intangible assets differently from the manner in which the same type of assets are treated in a business combination.

88. *This Chapter concludes that, under a valuation-based model, internally generated intangible assets do not warrant specific recognition criteria that differ from those adopted for intangible assets acquired in a business combination. Accordingly, all planned and unplanned internally generated intangible assets that satisfy the Framework's and IFRS 3's recognition criterion of 'reliable measurement of value' should be recognised.*

Implications for Current Requirements

89. This conclusion is significantly different from the current general recognition requirements for internally generated intangible assets contained in paragraph 21 of IAS 38 because IAS 38 does not contemplate initial fair value measurement. Instead it specifies cost, and accordingly adopts the probable future economic

benefits criterion. If a valuation-based model is adopted for internally generated intangible assets, IAS 38 would need to be substantially amended.

90. The conclusion in paragraph 88 of this Paper is also significantly different from the specific recognition requirements in paragraphs 51-61 of IAS 38. The implementation of the conclusion, therefore, would involve substantial amendments to the requirements in IAS 38. For instance, if a valuation-based model is adopted, implementation of the conclusion would lead to the removal of the requirements in paragraphs 63 and 64 of IAS 38, which prohibit the recognition of internally generated brands, mastheads, publishing titles, customer lists and items similar in substance as intangible assets.

INTERVIEWEES' PERSPECTIVES ON RECOGNITION CRITERIA

Probable Future Economic Benefits

91. Two interviewees from large accounting firms interviewed for the purpose of this project specifically noted that, prior to the introduction of IFRS 3, they were inclined to regard it as probable that the future economic benefits attributable to an internally generated intangible asset would flow to the entity holding the asset, but only if the asset was capable of being protected (for instance, a registered trademark existed) and/or was capable of being transferred/sold to a third party (that is, separable). Nevertheless, one of these interviewees suggested that it regarded legal ownership as being a sufficient but not a necessary condition for recognising an internally generated intangible asset, noting several situations where entities had undertaken civil proceedings to establish common law entitlements based on a pattern of use over internally generated brand names. Those from the consumer product firms interviewed expressed similar views to those from the large accounting firms.

92. A number of interviewees also regarded internally generated intangible assets such as software development expenditures and customer/mailing lists, which are not normally underpinned by explicit legal rights, as assets that typically satisfy the 'probable future economic benefit' asset recognition criterion.

Reliable Measurement

93. With respect to the reliably measurable recognition criterion, all the interviewees from large accounting firms and one from the consumer product corporations noted that reliability is a function of the inherent nature of the intangible asset and the availability of relevant data. This applies irrespective of whether the internally generated intangible asset is measured at cost or other value. For instance, mature brand names with a history of earnings were normally regarded as more reliably measurable than untested internally generated software or intellectual property that was still in a developmental stage. A history of earnings provides input for reliable estimates of future revenues and expenses. In addition, the availability of sales and licensing information for brand names through subscriber databases[20] facilitates the use of measurement methods such as the relief from royalty approach. In contrast, it may not be possible to determine a reliably measurable cost for internally generated software or intellectual property due to inadequate or non-existent accounting records.

[20] For instance, RoyaltySource (www.royaltysource.com), SDC Platinum (www.thomsonib.com/sp.asp) and Royaltystat (www.royaltystat.com).

CHAPTER 4 – MEASUREMENT

INTRODUCTION

94. This Chapter considers the main issues relating to the initial measurement of internally generated intangible assets, in particular whether the recognition criterion of reliable measurement of cost or value can be satisfied. It concludes with a standards-level view on the basis upon which internally generated intangible assets should be required to be initially measured.

95. Consistent with the approach to considering recognition issues, the measurement issues are considered in the context of a cost-based model and a valuation-based model. This is on the basis that, as noted in paragraph 58 of this Paper:

    (a) paragraph 38 of IFRS 3 and paragraph 33 of IAS 38 effectively treat the fair value measurement of intangible assets acquired in a business combination as cost, which is consistent with a cost-based model. Similarly, the requirements in IAS 16 for the initial measurement of internally generated tangible assets that are property, plant and equipment and, albeit to a lesser extent, the requirements in IAS 38 for the initial measurement of the limited types of internally generated intangible assets that it currently allows to be recognised, are consistent with a cost-based model; and

    (b) paragraph 36 of IFRS 3 requires the intangible assets acquired in a business combination to be initially measured at fair value, which is consistent with a valuation-based model.

96. This Chapter only considers the initial accounting for internally generated intangible assets and not whether changes in value should be recognised. Furthermore, under a cost-based model, it is conceivable that cost exceeds recoverable amount and therefore questions of impairment arise. Section 3 *[to be developed]* of this Paper considers issues relating to the subsequent accounting for internally generated intangible assets in both a cost-based model and a valuation-based model. From a subsequent measurement perspective, it is relevant to note that paragraph 100 of the Basis for Conclusions accompanying SFAS 19

Financial Accounting and Reporting by Oil and Gas Producing Companies (December 1977) contemplates 'discovery-value accounting', in which assets are initially measured at fair value but are not subsequently subject to remeasurement.

MEASUREMENT OF INTERNALLY GENERATED INTANGIBLE ASSETS AT COST

97. Paragraphs 98-110 consider an approach whereby planned internally generated intangible assets are initially measured in the same way as internally generated tangible assets (property, plant and equipment) – historical cost. The suitability of the broad cost-based principles in IAS 16 for internally generated intangible assets are considered. These principles are broadly aligned with paragraphs 65 to 67 of IAS 38, although IAS 38 applies them to a narrower group of internally generated intangible assets than planned internally generated intangible assets and commences capitalisation at a later stage in the process of developing an asset.

98. As implied by paragraph 316 of the IASB's Canadian Measurement Discussion Paper,[21] there are generally accepted standards for the historical cost measurement of assets that can be adapted to planned internally generated intangible assets. Although it is acknowledged that the frequent need to allocate on a one-to-many basis can be criticised, this criticism can equally be levelled at the initial measurement of property, plant and equipment under IAS 16. Moreover, cost allocation methods are well entrenched in accounting practice.

99. A core question to be addressed in relation to the initial accounting for costs associated with planned intangible items is which costs, if any, should be initially capitalised (and therefore initially recognised as part of the cost of an asset) and which costs should be initially written-off (and therefore recognised as expenses). The following outlines issues relevant to the capitalisation of historical costs.

[21] In this Paper, 'IASB's Canadian Measurement Discussion Paper' refers to the IASB's Discussion Paper *Measurement Bases for Financial Reporting – Measurement on Initial Recognition*, prepared by staff of the Canadian Accounting Standards Board (November 2005).

Initial Treatment of Costs

100. For any particular cost relating to a planned activity where an intangible asset exists or is being created the alternatives seem to be:

    (a) expense it immediately, and permanently;

    (b) expense it initially, and reinstate it to an attributable asset if the project for which the cost is incurred is subsequently found to be successful;[22]

    (c) capitalise it and simultaneously raise a valuation allowance (impairment) for the same amount. This is effectively the same as treatment (b), except that reversal of impairment is regarded as 'easier' to achieve than the reinstatement of previously expensed costs under current accounting standards;

    (d) capitalise it to an attributable asset for as long as the project for which the cost is incurred is expected to be successful and expense it if the project is subsequently found to be unsuccessful (a 'successful efforts' method);

    (e) expense it unless it can be demonstrated that the project to which it relates is technically and commercially feasible of completion, in which case capitalise it (as prescribed currently in IAS 38); and

    (f) capitalise it to an attributable asset (subject to impairment testing).

101. Treatments (a)-(e) are inconsistent with the conclusions drawn earlier in this Paper. Treatment (a) ignores that an asset (probable future economic benefits) may initially exist for a potentially ultimately successful or unsuccessful project. Treatments (b) and (c) also ignore that an asset may initially exist with a positive value, where research and development or another planned project has the potential to be ultimately successful. Furthermore, treatments (b) and (c) ignore that an asset may initially and subsequently exist with a positive value, even if a

[22] For instance, Lev (2001) proposes the recognition as assets of all intangible investments with attributable benefits that have passed certain prespecified technological feasibility tests and that, once asset recognition commences (postfeasibility test), all the project-related previously expensed research and development should also be recognised as assets. (pages 124 and 125)

project is unsuccessful. Treatment (d) fails to take account of an impairment prior to the outcome of a project being known, and by writing off all costs of a project that is expected to be unsuccessful again ignores that an asset may exist in relation to unsuccessful projects. Treatment (e) fails to take account of the existence of an asset prior to demonstrable technical or commercial feasibility of completion.

102. The initial treatment of costs under treatment (f) depends on the project for which costs are incurred (the unit of account). As noted in paragraph 31, the initial accounting for an internally generated intangible asset occurs up to completion or abandonment of the project the primary purpose of which is to create the asset, and therefore an asset in the nature of work in process may exist before the asset being developed exists. Where an asset exists, it would be appropriate to capitalise costs up until completion or abandonment of the project, (subject to a write-down to recoverable amount where necessary) – treatment (f). Impairment considerations include assessments of the probability of success of the project and the outcome being kept secret or protected in some way. As noted in paragraph 96, issues relating to impairment are *[to be]* considered in Section 3 of this Paper. Where an asset does not exist, costs should be expensed.

103. An internally generated intangible asset may not be identified until after some attributable costs, with the benefit of hindsight, have been incurred and expensed. A question arises as to whether in these cases only costs subsequent to the realisation that an asset exists should be capitalised and whether the previously expensed costs should be reversed through revenue or retained earnings and thereby capitalised. Capitalising costs only after identification of the asset sometime after it comes into existence would not provide a reliable measure of the cost of the asset. Although capitalising those costs and reversing previously expensed but attributable costs may provide a measure of cost, it would be questionable as to whether retrospective attribution of costs could be undertaken reliably and it would raise concerns about reinstatement. It is likely that such circumstances indicate the existence of an unplanned internally generated intangible asset and therefore would not be recognised under a traditional view of a cost-based model, rather than a planned internally generated intangible asset that would be recognised.

104. Relevant IASB standards that contain pertinent principles/guidance for cost allocation include IAS 1 *Presentation of Financial Statements* (see paragraph 92); IAS 2 *Inventories* (see paragraphs 10-22); IAS 11 *Construction Contracts* (see paragraphs 16-21); and IAS 16 *Property, Plant and Equipment* (see paragraphs 16-22 for example in relation to their discussion of the costs of self-constructed property, plant and equipment). Consistent with these Standards, costs allocated to planned internally generated intangible assets would include:

(a) direct costs (labour, materials, services); and

(b) indirect costs (allocation of appropriate operating overhead).

Conclusion

105. This Chapter concludes that, if a cost-based model is adopted, the principles for allocating costs to other types of assets should be adopted for planned internally generated intangible assets from the commencement of implementing the plan up until completion or abandonment of the plan.

Implications for Current Requirements

106. Implementation of this conclusion would require a number of amendments to the requirements in IAS 38. For instance, the requirements relating to cost allocation in paragraphs 65-67 of IAS 38 would need to be amended to align with the more general principles of cost allocation. Paragraph 65 of IAS 38 specifies, by cross-reference to paragraph 57 of IAS 38, that cost capitalisation only commences from the date the asset arising from development first meets the recognition criteria (which includes demonstrable technical and commercial feasibility of completion). This Paper contemplates capitalising costs from when a project is commenced, to the extent that such an asset would be identified if the entity were to be subject to acquisition.

Can the Cost of Internally Generated Intangible Assets be Reliably Measured?

107. A characteristic of planned internally generated intangible assets, such as the assets created by or being created by research and development projects, is that they have costs attributable to them. Upton (2001) observes (pages 69-70) that

the assets that result are created in much the same way as tangible assets. Upton (2001) also observes:

> From a purely bookkeeping standpoint, measuring the cost of these intangibles doesn't present any insurmountable accounting problems. (page 70)

108. The consensus amongst preparers and their advisors who were interviewed for the purpose of this project, particularly those from large accounting firms, consumer product corporations and one of the financial services corporations, was that the difficulties associated with identifying the costs to include in the asset-base limits the use of historical cost. Nevertheless, all of the interviewees, particularly those from large accounting firms, expressed a view that historical cost could provide a reliable measurement for some types of internally generated intangible assets, including research and development, software for internal administrative purposes and intellectual property, provided that the entity maintained adequate financial records. One of the large accounting firms interviewed noted that the quality of accounting systems normally varied between entities. Concerns about the adequacy of record keeping is a transitional issue.

Conclusion

109. This Chapter concludes that, if a cost-based model is adopted, it is reasonable to presume that historical cost can be reliably measured for all planned internally generated intangible assets. A transitional period may be warranted to allow entities time to develop adequate accounting systems. Cost is not applicable to unplanned internally generated intangible assets, because there is no basis for reliably attributing costs.

Implications for Current Requirements

110. The conclusion in paragraph 109 is broadly consistent with the current requirement in IAS 38 for the measurement of intangible assets arising from development that has satisfied the specified criteria. Implementation of this conclusion, therefore, would involve no additional changes to the requirements in IAS 38, so far as they relate to development that has satisfied the IAS 38 specific criteria. However, changes to facilitate recognition and measurement at cost of research, recognition of costs incurred prior to the IAS 38 specific criteria for

development, and recognition and measurement of other planned internally generated intangible assets (such as planned brand names), would be necessary.

MEASUREMENT OF INTERNALLY GENERATED INTANGIBLE ASSETS AT FAIR VALUE

111. The IASB Fair Value Measurements project, which is based on SFAS 157, is developing guidance for measuring fair value. The IASB has issued Discussion Paper 'Fair Value Measurements' (November 2006), part 1 of which is an Invitation to Comment and relevant IFRS guidance. The IASB's Business Combinations Phase II project is drawing conclusions based on the project. In particular, in relation to the initial measurement of assets acquired in business combinations, including intangible assets, the IASB's Business Combinations Phase II project is contemplating effectively adopting the fair value principles in SFAS 157. Paragraphs 113-137 of this Paper consider the implications of SFAS 157 for the initial measurement of internally generated intangible assets (planned or unplanned) under a valuation-based model.

112. SFAS 157 is a product of a standards-level project rather than a conceptual-level project. It does not specify that internally generated intangible assets should be initially measured at fair value. Rather, it provides guidance on the determination of fair value if standards specify fair value measurement.

What is Fair Value?

113. Paragraph 5 of SFAS 157 defines fair value as:

> the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

114. SFAS 157 establishes a three-level fair value hierarchy that prioritises the inputs to valuation techniques used to measure fair value. Each level of the hierarchy is discussed below in the context of internally generated intangible assets. The discussion below also includes a comparison of IFRS 3/IAS 38's current requirements for the fair value measurement of intangible assets acquired in business combinations with the SFAS 157 requirements.

Level 1 of the Fair Value Measurement Hierarchy: Use of Observable Inputs

115. Paragraph 24 of SFAS 157 describes Level 1 inputs as:

> quoted prices (unadjusted) in active markets for identical assets … that the reporting entity has the ability to access at the measurement date. An active market for the asset … is a market in which transactions for the asset … occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

116. The relevant extract from IAS 38 relating to the initial measurement of intangible assets acquired in business combinations that broadly corresponds to Level 1 is as follows:

> 39 Quoted market prices in an active market provide the most reliable estimate of the fair value of an intangible asset (see also paragraph 78). The appropriate market price is usually the current bid price. …

Although the IAS 38 description is different from the SFAS 157 description, it is apparent that their outcomes would be broadly the same. Therefore, if the requirements in SFAS 157 are adopted for internally generated intangible assets and incorporated into a stand-alone fair value measurements standard, it would be possible to delete the requirements in paragraph 39 of IAS 38 cited above and allow the requirements in a fair value measurements standard to apply in their own right.

Level 2 of the Fair Value Measurement Hierarchy: Use of Observable Inputs
and
Level 3 of the Fair Value Measurement Hierarchy: Use of Unobservable Inputs

117. Paragraph 28 of the SFAS 157 describes Level 2 inputs as:

> inputs other than quoted prices included within Level 1 that are observable for the asset … either directly or indirectly.

The paragraph goes on to explain that the observable inputs to which it refers include quoted prices for similar assets in active markets; quoted prices for identical or similar assets in markets that are not active; and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

118. Paragraph 30 of SFAS 157 describes Level 3 inputs as:

> unobservable inputs for the asset … Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset … at measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset … Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset … (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

119. The relevant extract from IAS 38 relating to the measurement of intangible assets acquired in business combinations that broadly corresponds to Level 2 and Level 3 is as follows:

> 39 … If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.
>
> 40 If no active market exists for an intangible asset, its fair value is the amount that the entity would have paid for the asset, at the acquisition date, in an arm's length transaction between knowledgeable and willing parties, on the basis of the best information available. In determining this amount, an entity considers the outcome of recent transactions for similar assets.
>
> 41 Entities that are regularly involved in the purchase and sale of unique intangible assets may have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in a business combination if their objective is to estimate fair value and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, when appropriate:
>
> (a) applying multiples reflecting current market transactions to indicators that drive the profitability of the asset (such as revenue, market shares and operating profit) or to the royalty stream that could be obtained from licensing the intangible asset to another party in an arm's length transaction (as in the 'relief from royalty' approach); or
>
> (b) discounting estimated future net cash flows from the asset.

IAS 38 describes the techniques differently from SFAS 157's description. For example, IAS 38 refers specifically to a potential need to address changed economic circumstances, that is, it specifically highlights that prices might be those from the past. Furthermore, IAS 38 prescribes an entry price (being the amount that the entity would have paid for the asset – paragraph 40 of IAS 38) rather than an exit (selling) price prescribed by SFAS 157. Despite these differences, IAS 38's and SFAS 157's outcomes would be broadly the same. Paragraph A25 of SFAS 157 states that: "Assumptions about risk include the risk

inherent in a particular valuation technique used to measure fair value … and/or the risk inherent in the inputs to the valuation technique". If the SFAS 157 requirements are adopted for internally generated intangible assets, it would be inappropriate to delete entirely paragraphs 39-41 of IAS 38 in the event that a stand-alone fair value measurements Standard is issued to the extent they provide useful clarification of the application of fair value measurement for intangible assets, including internally generated intangible assets.

Can the Fair Value of Internally Generated Intangible Assets be Reliably Measured?

120. Whether Levels 1 to 3 inputs as described in SFAS 157 are available for determining the fair value of a particular internally generated intangible asset (or group of assets that includes one or more internally generated intangible assets) is a question of fact, in the same way that it is a question of fact for intangible assets acquired in business combinations.

121. Paragraph 2(b) of SFAS 157 anticipates that the fair value of certain assets cannot be reliably measured. In particular, it notes that:

> This Statement does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of this Statement.

122. IAS 38, in specifying requirements for the measurement of intangible assets acquired in a business combination, also anticipates a reliable measure of fair value cannot be determined in all circumstances. This is acknowledged in paragraph 38 of IAS 38, which follows paragraphs 35 to 37 that assert that reliable measurement of fair value is attainable in all other circumstances:

> 35 The fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be recognised separately from goodwill. When, for the estimates used to measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities, that uncertainty enters into the measurement of the asset's fair value, rather than demonstrates an inability to measure fair value reliably. If an intangible asset acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably.
>
> 36 An intangible asset acquired in a business combination might be separable, but only together with a related tangible or intangible asset. For example, a magazine's publishing title might not be able to be sold separately from a related subscriber database, or a trademark for natural spring water might relate to a particular spring and could not be sold separately from the spring. In such cases, the acquirer recognises the group of assets as a single asset separately from goodwill if the individual fair values of the assets in the group are not reliably measurable.

> 37 Similarly, the terms 'brand' and 'brand name' are often used as synonyms for trademarks and other marks. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise. The acquirer recognises as a single asset a group of complementary intangible assets comprising a brand if the individual fair values of the complementary assets are not reliably measurable. If the individual fair values of the complementary assets are reliably measurable, an acquirer may recognise them as a single asset provided the individual assets have similar useful lives.
>
> 38 The only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination are when the intangible asset arises from legal or other contractual rights and either:
> (a) is not separable; or
> (b) is separable, but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables.

123. Although paragraph 35 of IAS 38 states that: "The fair value of intangible assets acquired in business combinations can **normally** be measured with sufficient reliability to be recognised separately from goodwill" (emphasis added), the IAS 38 rebuttable presumption of reliable measurement only applies to finite useful life intangible assets. This arguably reflects a view in IAS 38 that it is more inappropriate to include finite useful life intangible assets than indefinite useful life intangible assets within goodwill, presumably because both goodwill and indefinite useful life intangible assets are not subject to amortisation. In the absence of the recognition of internally generated goodwill, the same rationale for distinguishing between the reliability of measurement of indefinite life intangible assets versus finite life intangible assets does not apply in the context of internally generated intangible assets. However, it may also be that the lack of the rebuttable presumption for indefinite life intangible assets in IAS 38 reflects a concern that it is more difficult to distinguish indefinite life intangible assets than finite life intangible assets from goodwill. Consistent with paragraph 2 of this Paper, this Chapter accepts the approach taken in IAS 38 for intangible assets acquired in a business combination and therefore that normally the fair value of indefinite life internally generated intangible assets can be measured reliably and that there is a rebuttable presumption that the fair value of finite life internally generated intangible assets can be measured reliably. The appropriateness of maintaining the distinction in IAS 38 for intangible assets acquired in business combinations (and therefore potentially extending it to internally generated intangible assets) is outside the scope of this project. However, issues relating to

defining and distinguishing between indefinite and finite life assets is pertinent to subsequent accounting, and are *[to be]* addressed in Section 3 of this Paper.

124. Consistent with paragraphs 36-38 of this Paper, irrespective of the Level of the fair value measurement hierarchy adopted and the manner in which the intangible asset is acquired, measurement should be of the fair value of the economic phenomenon reflected in the descriptor of the asset. Care must be taken not to double-count value by including it in more than one asset. Paragraph 43 of IAS 36 provides some guidance on the double-counting issue. It indicates that, to avoid double-counting, estimates of future cash flows do not include cash inflows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review. The value attributed to the asset as it is described should not include the value of attributes unless its inclusion would be generally understood by users through the descriptor. For example, consider an entity that has proprietary technology or know how and applies it when servicing its customers. The assets of the entity would include technology, know-how, workforce[23] and customer relationships. When measuring the individual intangible assets, care must be taken to avoid double-counting or overlap between assets.

125. Some industries or countries may have more Level 2 data than others. For example, in some countries intangible assets may be traded and therefore Level 2 inputs may be available but in other countries where the same kind of assets are not traded, only Level 3 inputs may be available.

126. Even if it is concluded that Levels 1 and 2 inputs are not available for some internally generated intangible assets currently, new markets for intangible assets

[23] The October 2006 *IASB Update* notes that:

> "The Board tentatively decided not to continue with the proposal in the Business Combinations Exposure Draft to prohibit the recognition of an assembled workforce separately from goodwill.
>
> The Board also tentatively decided to clarify that an assembled workforce is a collection of employees that allows an acquirer to continue to operate immediately following an acquisition. In other words an assembled work force has value because an acquirer does not need to go through the process of finding, recruiting and training the employees because they are already in place and operating at the time of the acquisition. The value of an assembled workforce does not represent the intellectual capital of the workforce of which the acquirer has obtained the benefit as a result of the acquisition."

may emerge in the future as markets develop. A financial analyst interviewed for the purpose of this project commented that markets are emerging as increasingly more transactions in internally generated intangible assets, such as brand names, occur. However, currently there is limited information provided in financial reports about such transactions to inform the market and facilitate analysis by market participants.

127. Furthermore, there is evidence to suggest that the fair value of many types of internally generated intangible assets can be reliably determined. For example, anecdotal evidence indicates that there have been a number of business combinations where internally generated intangible assets were central to the negotiations and that the market effectively valued these items prior to the actual takeover. Two examples of business combinations where internally generated intangible assets were a significant focus of the negotiations and had an observable impact on the acquisition price include the takeover of the German phone company Mannesmann Mobilfunk by British Vodaphone in 2000 (customer contracts and intellectual property) and the merger between American Online and Time Warner in 2001 (subscriber lists and customer contracts).

128. If the fair value of an intangible asset acquired in a business combination can be reliably determined, the same type of intangible asset should be able to be fair valued in the absence of a business combination. Accordingly, the IFRS 3 (or SFAS 157) principles for initially determining the fair value of intangible assets acquired in a business combination could be applied for initially measuring the same type of intangible assets that are internally generated. Arguably, consistent with paragraphs 41 and 42 of this Paper, determining the fair value of an internally generated intangible asset of an entity is less onerous for the entity than determining the fair value of an intangible asset acquired in a business combination because the entity presumably knows its own assets better than assets it acquires in a business combination, particularly in a 'hostile' business combination. It is relevant to note that paragraph 30 of SFAS 157 does not require an entity to undertake all possible efforts to obtain information about market participant assumptions, but requires it to do so if it is reasonably available without undue cost and effort.

129. Applying IFRS 3 principles to internally generated intangible assets by analogy raises the question as to whether the principles in IFRS 3 relating to provisional accounting are applicable to an internally generated intangible asset. An inability to reliably measure fair value differs from the provisional accounting situation that is anticipated in paragraphs 61 and 62 of IFRS 3 for the initial accounting for a business combination. As discussed in paragraphs BC161 and BC162 that accompany IFRS 3, the IASB regards the use of provisional values as a practical solution to situations where required inputs are not available until after the acquisition date. Where an internally generated intangible asset satisfies the definition and separate recognition criteria at the reporting date, typically its final fair value would be available. In the rare circumstances that is not the case, consistent with the provisional accounting principles in IFRS 3, the internally generated intangible asset should be measured provisionally, where it can be determined reliably, rather than not be measured at all.

130. Comments by people interviewed for the purpose of this project indicate that fair values can be reliably determined for many internally generated intangible assets, although questions about the need for, and concerns about the veracity of, those values were expressed by some users (financial analysts). The results of the interviews are detailed in paragraphs 131-136 below.

Interviewees' Perspectives on Reliable Measurement of Fair Value of Internally Generated Intangible Assets

Preparers of financial reports and their advisors

131. All of those preparers and their advisors interviewed for this project acknowledged the trade-off between relevance and reliability that occurs when selecting between different measurement methods for internally generated intangible assets. Most interviewees indicated that, prior to the introduction of IAS 38, they adopted a hierarchical approach broadly similar to that reflected in SFAS 157 when selecting an appropriate measurement method for internally generated intangible assets, although they also anticipated measurement at cost as a surrogate for fair value in certain circumstances. For the majority of interviewees, particularly those from large accounting firms and consumer

product corporations, amounts determined using Level 1 inputs or Level 2 inputs were preferred over all other measurement methods for measuring internally generated intangible assets. Furthermore, interviewees indicated that, in the event that reporting entities were permitted or required to recognise internally generated intangible assets, the measurement methodologies currently being applied to initially measure intangible assets acquired in business combinations under IFRS 3 (and therefore paragraphs 39 to 41 of IAS 38) are likely to be similarly applied to internally generated intangible assets.

132. A number of the interviewees, particularly those from large accounting firms, consumer product corporations and one of the telecommunications and broadcasting corporations, noted that the lack of readily observable market prices (Level 1) for some intangible assets, including brand names, research and development, internally generated software and intellectual property, had constrained them and/or entities they dealt with from recognising internally generated intangible assets in the past. Nevertheless, most of the interviewees felt that this alone did not prevent the determination of a reliable measure of some internally generated intangible assets for external financial reporting purposes.[24] The most important factor mentioned by interviewees in relation to the determination of a reliable measure of an internally generated intangible asset was whether the cash flows attributable to the intangible asset could be separately identified (relevant to Level 3 of the fair value measurement hierarchy). In any case, in the absence of observable market prices for a directly comparable intangible asset, some interpretation and adjustments of information obtained from subscriber databases (Level 2) were necessary to ensure that the measurement attributed to a particular intangible asset represented a reliable measurement for external financial reporting purposes.

133. A number of the interviewees, particularly those from large accounting firms and consumer product corporations, noted their experience with measurement models based on entity-specific information and expectations (potentially Level 3 of the fair value measurement hierarchy). This is particularly the case where the market

[24] Although management would be expected to understand measurements derived for internal purposes, it is possible that external users could be misled by those measures. Therefore, reliable

for the intangible asset is relatively immature and consists of few observable market transactions, or the intangible asset has a number of unique characteristics that make direct comparisons with other markets difficult. Consequently, these interviewees indicated that, if fair value as described under Level 1 could not be reliably measured, they would first seek an appropriate measurement method based on market-specific data and expectations (fair value as described under Level 2) and entity-specific data and expectations (potentially Level 3). Interviewees indicated that measurement techniques such as the capitalisation of discounted cash flows and excess of profits and capitalisation of earnings multiples approaches could provide measurements that are reliable, depending upon the quality and availability of entity-specific information.

134. A number of the interviewees, particularly those from large accounting firms, expressed a view that the fair value of an internally generated intangible asset cannot be reliably measured when identifiable cash flows cannot be directly attributed to the intangible asset, or the intangible asset is in an early stage of development. They suggested that historical cost could be used as an upper limit for the purposes of measurement, or else a proxy for replacement cost. However, other interviewees, also from large accounting firms, noted that the amount an entity can spend on developing an intangible asset is largely speculative and therefore is unlikely to reflect the amount the entity would spend to reconstruct the asset, or what another entity would be willing to spend to acquire it. They acknowledged, however, that historical cost (and replacement cost) could provide a reasonable cross or 'reality check' against other measures. Although SFAS 157 anticipates valuation techniques consistent with the market approach, income approach, and/or cost approach (see paragraph 18 of SFAS 157), it is apparent that a cost approach would only be appropriate if it satisfied the criteria in Level 3. Therefore, capitalisation of historical costs is unlikely to be an acceptable technique for determining fair value on initial recognition of internally generated intangible assets.

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measurement for external financial reporting purposes is arguably a higher hurdle than for internal reporting purposes.

Users of financial reports (financial analysts)

135. Where fair values are provided in financial reports, there appears to be healthy scepticism among financial analysts about the veracity of those values. The financial analysts interviewed commented that, where fair values are provided in financial reports, they should be determined by an independent valuer and supported by disclosure of information about the measurement model adopted, together with key assumptions and sensitivities. Issues relating to disclosures are considered in Chapter 5.

136. An independent valuation expert interviewed commented that although a broad level of valuation knowledge and experience may not currently exist throughout the world, which perhaps leads to concerns about the veracity of values, that is a consequence of there being no current requirement for the determination of fair value. He observes that, if fair value were to be prescribed for the financial reporting of internally generated intangible assets, the skills would develop and spread from those jurisdictions where the skill base lies. He believes that the fair value of the vast majority of internally generated intangible assets can be determined reliably for external financial reporting purposes.

Conclusion

137. *This Chapter concludes that internally generated intangible assets are capable of being reliably measured at fair value to the same degree that IFRS 3 asserts that the fair value of the same types of intangible assets acquired in a business combination are capable of reliable measurement. Consistent with the emerging view from the Business Combinations Phase II project, SFAS 157 provides a suitable basis for specifying the determination of fair value of internally generated intangible assets.*

SHOULD INTERNALLY GENERATED INTANGIBLE ASSETS BE MEASURED AT COST OR FAIR VALUE?

138. It is difficult to decide between cost and fair value as a basis for measuring internally generated intangible assets because the IASB has not yet resolved the more general question of measurement at a conceptual level. Therefore, the

following discussion is presented pending the outcome of the IASB deliberations on measurement issues from a conceptual perspective.

139. Some argue that it is not necessary to answer the cost/fair value question even at a standards-level because, as already demonstrated in this Paper, internally generated intangible assets can be accounted for within the general principles of the *Framework*. Furthermore, they argue that the existing suite of IASB Standards allow a choice between cost and fair value and that choice should continue to be available for internally generated intangible assets until it is reviewed for all types of assets. However, retaining the choice has greater implications in the context of internally generated intangible assets than most other asset classes given the number and significance of internally generated intangible assets that do not have attributable costs because they are unplanned. Therefore, there is a potential for the absence of a specified measurement basis to give rise to an even greater lack of comparability than is the case for other asset classes.

Arguments For and Against Initially Measuring Internally Generated Intangible Assets at Cost

140. Arguments in favour of initially measuring internally generated intangible assets at cost include that it is consistent with the treatment of internally generated tangible assets (property, plant and equipment). Furthermore, some argue that it is consistent with IFRS 3 principles because IFRS 3 uses fair value merely as a surrogate for cost (see for example paragraph 33 of IAS 38). However, the direction of the Business Combinations Phase II project indicates that the current IASB thinking is that the underlying principle is fair value rather than cost.

141. Some argue that a benefit of a cost-based model for planned internally generated intangible assets is that, compared with a valuation-based model, it is closer to the current requirements in IAS 38. Furthermore, it generally provides a cost-effective way of measuring internally generated intangible assets and relies on traditional recognition triggers, rather than using reporting date as a recognition trigger. Subsequently, subjecting those assets to impairment testing only where impairment is indicated is also more cost-effective than a valuation-based model.

However, it runs a greater risk that the carrying amount exceeds the recoverable amount.

142. Under a traditional view of a cost-based model, unplanned internally generated intangible assets are not recognised. A consequence of requiring the recognition of planned internally generated intangible assets and not allowing the recognition of unplanned internally generated intangible assets is that it may provide an incentive for an entity to inappropriately contrive planned or unplanned assets to suit the entity's, rather than users', financial reporting interests. As noted in paragraph 27 of this Paper, the degree to which planned assets are identified is determined by the foresight of management.

143. Based on comments from users (financial analysts) of financial reports interviewed for the purpose of this project, cost information is necessary to enable financial analysts to make their own assessments of value and performance. Where provided on a project/major activity basis with a distinction between successful and unsuccessful projects, cost information enables analysts to monitor the success rate of an entity's expenditure over time. Given the relative sophistication of financial analysts and their focus on cash flows, they do not even regard it as necessary for costs to be capitalised and recognised as assets. However, where costs are capitalised, financial analysts find it useful for there to be disclosure of the management's rationale for capitalisation. These findings are discussed further in Chapter 5.

144. To overcome concern about the traditional view of a cost-based model failing to recognise unplanned internally generated intangible assets, some argue that a modified view of a cost-based model should be adopted under which unplanned internally generated intangible assets are initially measured at fair value as a surrogate for cost; and planned internally generated intangible assets are initially measured at cost (subject to impairment considerations). This approach may have some merit. It results in the identification and recognition of all internally generated intangible assets. Although more onerous from a preparer's perspective than the traditional view of a cost-based model, it is not as onerous as the valuation-based model. Furthermore, it more clearly distinguishes initial measurement from ongoing measurement and is arguably consistent with IFRS 3

principles. In relation to planned internally generated intangible assets, it is consistent with the treatment of internally generated tangible assets reflected in IAS 16. In relation to unplanned internally generated intangible assets, it is consistent with the treatment of assets acquired at no cost and discovery-value accounting (see paragraph 96 of this Paper). However, like the traditional view of the cost-based model, it can be criticised for treating planned and unplanned internally generated intangible assets differently.

Arguments For and Against Initially Measuring Internally Generated Intangible Assets at Fair Value

145. Arguments in favour of measuring internally generated intangible assets at fair value include that it provides relevant information and results in a consistent treatment of the same kind of assets acquired in a business combination under IFRS 3. Furthermore, it does not necessarily imply anything about subsequent measurement as it is consistent with discovery-value accounting (see paragraph 96 of this Paper). An amount determined under Levels 1, 2 or 3 of the fair value measurement hierarchy as described in SFAS 157 was overwhelmingly preferred over cost by most preparers or their advisors interviewed on the basis of their experience and that it provides relevant information by capturing the expectations of future cash flows generated by an asset. In contrast, historical cost is not capable of capturing the future economic benefits attributable to an internally generated intangible asset.

146. However, some individuals interviewed noted that a requirement for internally generated intangible assets to be measured at fair value gives rise to particular audit issues. The work involved in reliably determining fair value could affect the ability of entities to report on a timely basis. They also argue that fair value measurement would be difficult to justify on cost-benefit grounds. This comment was made particularly in relation to a requirement to measure fair value on an ongoing basis, and is *[to be]* discussed in Section 3 of this Paper.

147. Some are concerned that, under a valuation-based model, in the absence of any other 'trigger' or 'control point', the only 'trigger' for recognising an internally generated intangible asset is a reporting date. They accept that this may be

suitable, although onerous, for the initial measurement of a planned internally generated intangible asset on completion or abandonment of a project or an unplanned internally generated intangible asset. However, planned internally generated intangible assets that are work in process would need to be valued at fair value at each reporting date, which is perceived as particularly onerous from a preparer's perspective. They argue that at least a cost-based approach to measurement of the work in process asset should be adopted.

148. Financial analysts interviewed expressed a view that, given their focus on cash flows, fair value measurement of internally generated intangible assets (and for that matter intangible assets acquired in business combinations) for financial reporting purposes is unnecessary. Financial analysts see their role as determining value and therefore a fair value asserted by an entity's management is not particularly helpful. Although it was acknowledged that it can be useful as a point of comparison, some financial analysts questioned whether the benefits outweighed the costs incurred by the entity in determining fair value. They expressed concern that fair values can be misleading to the extent there is a lack of consistency in the measurement methods adopted, leading to lack of comparability. Some argue that analysts have a vested interest in advocating cost over fair value information to the extent analysts aim to protect the investments they have made in their proprietary models that require specific inputs.

Conclusion

149. On balance, consistent with the principles in IFRS 3, this Chapter concludes that both planned and unplanned internally generated intangible assets should be required to be initially measured at fair value (as that notion is applied in SFAS 157) where fair value can be estimated with an acceptable level of reliability.

Implications for Current Requirements

150. This conclusion is significantly different from the current requirements for measurement of internally generated intangible assets in IAS 38. Therefore, implementation of this view would involve a number of substantial amendments to the requirements in IAS 38, particularly paragraphs 18-24, to require internally

generated intangible assets to be recognised initially at fair value where fair value rather than cost can be reliably determined.

CHAPTER 5 – PRESENTATION/DISCLOSURE

INTRODUCTION

151. This Chapter considers the main issues relating to the presentation of and disclosures about internally generated intangible assets. In particular, it considers:

    (a) disclosure as a substitute for recognition of internally generated intangible assets;

    (b) presentation and disclosure of information about internally generated intangible assets that satisfy both the definition and recognition criteria of assets; and

    (c) disclosure of information about internally generated intangible assets that satisfy the definition but fail the recognition criteria of assets.

152. For the purpose of this Chapter, the term 'presentation' is used to describe the manner in which items recognised on the face of the financial statements are shown, whereas the term 'disclosure' is used to describe information displayed in the notes or supplementary schedules of a financial report.

153. The discussion in this Chapter is limited to the presentation of and disclosures about internally generated intangible assets in financial statements and notes to the financial statements. Consistent with the approach adopted in Chapters 2 and 4, where relevant, the main issues are examined in the context of whether:

    (a) the current presentation and disclosure principles adopted for intangible assets acquired in business combinations are suitable for the same type of intangible assets if they were internally generated; and

    (b) whether the current presentation and disclosure principles adopted for internally generated tangible assets are suitable for internally generated intangible assets.

Consistent with the approach adopted in Chapter 4, these issues are considered in the contexts of a cost-based model and a valuation-based model. Additional presentation and disclosure issues identified by interviewees are also considered.

154. This Chapter also considers other IASB Standards that contain principles/guidance relating to presentation and disclosure that may be relevant to internally generated intangible assets, such as IFRS 6 *Exploration for and Evaluation of Mineral Resources*, IFRS 7 *Financial Instruments: Disclosures* and IAS 40 *Investment Property*.

155. Given the nature of internally generated intangible assets, traditional disclosures may not provide sufficient information for users and it may be necessary to investigate other approaches, which are beyond the scope of this Paper, in order to identify solutions that better satisfy users' needs. In particular, consideration could be given to work being undertaken in related fields, including:

(a) *A Guideline for Intellectual Capital Statements*, published by the Danish Agency for Trade and Industry;[25] and

(b) the Management Commentary Discussion Paper, prepared for the IASB by staff of its partner standard-setters and others.[26]

156. This work in related fields provides opportunities for standard-setters to think beyond the traditional scope of financial reports and may also provide a basis for supplementing the conclusions in this Paper. For instance, paragraph E12 of the Management Commentary Discussion Paper (2005) states that, in relation to internally generated brands:

> If management regards brands as a key resource/risk of the entity, MC might contain:
> (a) trends of growth rates for the markets (eg both market and geography) in which the branded products are sold, any lead economic indicators relating to market growth

[25] Danish Agency for Trade and Industry – *A Guideline for Intellectual Capital Statements – A Key to Knowledge Management* (November 2000), Danish Agency for Trade and Industry, Copenhagen, Denmark (www.euintangibles.net/library/localfiles/ICS-Uksprog.pdf) (Referred to in this Chapter as Danish Agency for Trade and Industry (2000)).

[26] Discussion Paper *Management Commentary*. A paper prepared for the IASB by staff of its partner standard-setters and others and published for comment by the International Accounting Standards Board (October 2005), IASB, London, United Kingdom. (Referred to in this Chapter as Management Commentary Discussion Paper (2005)).

(eg demographics if particular brands appeal to any one age or socio-economic group), both historical and forward-looking.

(b) objectives and strategies for brand acquisition, development and maintenance.

(c) measures used by management to assess and manage performance against brand replacement strategies, eg historical market position, volume of units sold, brand awareness ratings, as well as future targets for the same measures.

DISCLOSURE AS A SUBSTITUTE FOR RECOGNITION

157. Some argue that disclosure provides an acceptable alternative to recognition as a means of incorporating into financial reports information about internally generated intangible assets. Considering the uncertainties that generally surround the future outcomes from intangible assets, and the absence in most cases of active markets for intangible assets, some adopt the view that it is preferable to disclose information about internally generated intangible assets in the notes to financial statements, rather than recognise those assets, even if they satisfy the relevant recognition criteria. In such circumstances, disclosure in the notes would ensure that users are provided with information that would not otherwise be provided. In addition, note disclosures may be regarded by some as an interim solution to be applied until such time as users, preparers and auditors are comfortable with the recognition of internally generated intangible assets in the financial statements. Others argue that note disclosures are insufficient and entities that hold intangible assets should prepare separate qualitative reports to accompany their financial reports. For instance, the Danish Agency for Trade and Industry (2000) suggests that companies should prepare intellectual capital statements, which report on:

> the company's efforts to obtain, develop, share and anchor the knowledge resources required to ensure future results. The intellectual capital statement can contribute to creating value for the company by improving the basis for growth, flexibility and innovation. Its merits lie in expressing the company's strategy for what it must excel at in order to deliver satisfactory products or services. (page 13)

Nevertheless, the Danish Agency for Trade and Industry (2000) advise that:

> The objective of an intellectual capital statement is not to calculate the value of the company's knowledge in financial terms. Also, this is probably not feasible. Thus, an intellectual capital statement cannot be used to explain the difference between a company's book value and its market value… (page 14)

158. In contrast, others argue that note disclosures and supplementary reports are a 'second best' solution, particularly within the current reporting framework. For instance, some argue that note disclosures would not enhance the comparability of

financial statements on the basis that many intangible assets acquired in business combinations are presented on the face of the financial statements at their fair values as at the acquisition date, whereas the same kinds of intangible assets that have been internally generated may only be disclosed in the notes in purely qualitative terms. Others argue that note disclosure belies the importance management and users attribute to intangible assets generally. These views are consistent with paragraph 82 of the *Framework*, which states that:

> Items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

These views are also consistent with the findings from some empirical studies that there is evidence to suggest that footnote disclosures are not efficiently impounded into share prices.[27]

Interviewees' Perspectives

159. Those interviewed from the consumer product corporations expressed concerns with the disclosure of information regarding internally generated intangible assets in the notes as a substitute for recognition. They argued that note disclosures do not give due prominence to items that corporations regard as critical to their respective operations and diminish the comparability of their financial statements to the financial statements of other entities, particularly other entities that have acquired brand names separately or in business combinations. For instance, the preparers from one of the consumer product corporations indicated that the adoption of IAS 38 meant that the corporation would no longer be able to recognise certain internally generated intangible assets and therefore would use note disclosures more extensively. These preparers noted, however, that, consistent with the importance of the corporation's brand names to its operations, they would prefer to recognise the corporation's identifiable brand names on the

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[27] For instance, footnote 56 in the Management Commentary Discussion Paper (2005), refers to Landsman, W. and J. Ohlson (1990), 'Evaluation of market efficiency for supplementary accounting disclosure: the case of pension assets and liabilities', *Contemporary Accounting Research*, Volume 7, pp.185-198. However, the same footnote also refers to some empirical studies that indicate that note disclosures are impounded into share prices. For instance, Harris, T. and J. Ohlson (1998), 'Accounting disclosures and the market's valuation of oil and gas properties', *The Accounting Review*, Volume 62, pp.651-670; Barth, M. (1994), 'Fair value accounting: evidence from investment securities and the market value of banks', *The Accounting Review*, Volume 69, pp.1-25.

face of the financial statements, irrespective of the manner in which they are acquired. The preparers from the other consumer product corporation suggested that disclosure in the notes instead of recognition on the face of the financial statements would give rise to a 'second set' of financial accounts.

160. The preparers from one of the financial services corporations expressed concerns with disclosure in the notes instead of recognition on the face of the financial statements and questioned the usefulness of note disclosures that are predominantly qualitative. In addition, they indicated that the levels of disclosure and audit risks associated with providing quantitative information in the notes is comparable to the levels of disclosure and audit risks associated with recognising the same information on the face of the financial statements. Consequently, these preparers indicated that they could see little, if any, justification in disclosing quantitative information in the notes that exhibits the same qualitative characteristics as information disclosed on the face of the financial statements. Furthermore, an interviewee from one of the accounting firms noted that, if users' expectations in relation to items disclosed in the notes are not fulfilled, the market usually reacts unfavourably and with little or no acknowledgement that the level of uncertainty associated with such items might be greater than the level of uncertainty associated with items presented on the face of the financial statements.

161. An interviewee from one of the other accounting firms suggested that users are likely to be more sceptical about the quality of information contained in the notes because the information is not recognised on the face of the financial statements. This interviewee also noted that management and directors generally question the usefulness of information disclosed in notes compared with information recognised on the face of the financial statements, particularly considering the number of assumptions that often underpin note disclosures and the concomitant risks associated with these assumptions.

162. Consistent with the views expressed by a number of the other interviewees, an independent valuation expert interviewed commented that users tend to heavily discount the usefulness of information disclosed in the notes. Moreover, the interviewee noted that disclosure in the notes of information in relation to

intangible assets that satisfy the recognition criteria contradicts the importance management and users place on intangible assets generally.

Conclusion

163. This Chapter concludes that note disclosure of internally generated intangible assets is not a satisfactory substitute for recognition.

PRESENTATION AND DISCLOSURE TO FACILITATE AND SUPPLEMENT RECOGNITION

164. While disclosure is not a satisfactory substitute for recognition, recognition on its own is not sufficient to ensure that financial reports provide decision useful information that is adequate for users. For instance, paragraph 21 of the *Framework* states that:

> Financial reports also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement…

Sub-paragraph 103(c) of IAS 1 clarifies that the notes shall:

> …provide additional information that is not presented on the face of the balance sheet, income statement, statement of changes in equity or cash flow statement.

165. Many of the disclosure requirements in relation to assets in IAS 1 are sufficient to facilitate the separate presentation of internally generated intangible assets that meet the relevant definition and recognition criteria without the need for amendment. In addition to the requirement in paragraph 68 of IAS 1 for entities to present, as a minimum, intangible assets as a line item on the face of the balance sheet, paragraphs 69, 71 and 72 state that:

> 69. Additional line items, headings and subtotals shall be presented on the face of the balance sheet when such presentation is relevant to an understanding of the entity's financial position.
>
> 71. This Standard does not prescribe the order or format in which items are to be presented. Paragraph 68 simply provides a list of items that are sufficiently different in nature or function to warrant separate presentation on the face of the balance sheet. In addition:
> (a) line items are included when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of an entity's financial position; and
> (b) the descriptions used and the ordering of items or aggregation of similar items may be amended according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity's financial position…

> 72. The judgement on whether additional items are presented separately is based on an assessment of:
> (a) the nature and liquidity of assets;
> (b) the function of assets within the entity…

166. Moreover, depending on the outcome of the issues raised in Chapters 2 to 4 of this Paper, IAS 1 may require entities to present recognised planned internally generated intangible assets separately from recognised unplanned internally generated intangible assets. Paragraph 73 of IAS 1 states that:

> The use of different measurement bases for different classes of assets suggests that their nature or function differs and, therefore, that they should be presented as separate line items. For example, different classes of property, plant and equipment can be carried at cost or revalued amounts in accordance with IAS 16 *Property, Plant and Equipment*.

167. It is also relevant to note that IAS 1 currently requires entities to disclose information in relation to the accounting policies adopted and judgements made by management that would assist users in understanding the entity's reported financial performance and financial position. Paragraphs 113 and 116 of IAS 1 state that:

> 113. An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 116), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.
>
> 116. An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:
> (a) their nature; and
> (b) their carrying amount as at the balance sheet date.

168. The following considers disclosure issues in the contexts of a cost-based model and a valuation-based model.

Cost-Based Model

Descriptors for Planned Internally Generated Intangible Assets

169. As discussed in paragraphs 60 and 63 of this Paper, under the cost-based model, only planned internally generated intangible assets would be recognised. Furthermore, for initial measurement purposes, where an asset exists the appropriate treatment under a cost-based model is to capitalise the costs from commencement of implementing the plan up until completion or abandonment of

the project (subject to a write-down to recoverable amount where necessary). Therefore, consistent with paragraph 31 of this Paper, an asset in the nature of work in process may exist before the asset being developed exists. Consequently, the question arises as to how, for instance, a planned brand name that is work in process should be presented in the balance sheet. For example, should it be presented as 'Capitalised Brand Development Costs' or 'Brand – Work in Process'? The former descriptor emphasises the capitalised nature of the item and suggests nothing about the future of the project, whereas the latter possibly implies that the costs will eventually be reclassified to the completed intangible asset.

170. Consistent with the discussion in paragraph 38 of this Paper, due to the different ways in which entities structure and manage their projects and the different objectives they aim to achieve, the description that is appropriate to be adopted for an item can only be considered on an item-by-item/asset-by-asset basis. Nevertheless, as discussed in paragraphs 36-38 of this Paper, the descriptor adopted for the purpose of financial reporting should depict the item's economic phenomena and be meaningful in its commonly understood way. To this end, descriptors such as 'In-process Research and/or Development' and 'Brand – Work in Process' are preferable to descriptors such as 'Capitalised Research and/or Development Costs' or 'Capitalised Brand Development Costs' for the purpose of presentation of planned internally generated intangible assets on the basis that the former descriptors more clearly convey the expectation of economic benefits in the future from a completed asset.

171. The assertion that the descriptor adopted for the purpose of financial reporting should depict the item's economic phenomena and be meaningful in its commonly understood way is consistent with the approach adopted in IAS 38. For instance, paragraph 119 of IAS 38 states that:

> A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. Examples of separate classes may include:
> (a) brand names;
> (b) mastheads and publishing titles;
> (c) computer software;
> (d) licences and franchises;
> (e) copyrights, patents and other industrial property rights, service and operating rights;
> (f) recipes, formulae, models, designs and prototypes; and
> (g) intangible assets under development.

> The classes mentioned above are disaggregated (aggregated) into smaller classes if this results in more relevant information for the users of the financial statements.

172. Some entities appear to be reticent to use the descriptor ‘intangible assets’ in their financial reports due to adverse market and/or regulator reactions to that term and, accordingly, use other terms that do not generate the same adverse reactions but sufficiently describe the terms more appropriately, such as ‘service concessions’. For instance, the preparers from one of the telecommunication and broadcasting corporations indicated that it is reticent to describe items as ‘intangible assets’ in its financial statements. In the past, the corporation had experienced adverse market reactions to the recognition of such items.

173. Consistent with the conclusion in paragraph 50 of this Paper, the principles adopted in applying IFRS 3 should be applied in determining appropriate descriptors for internally generated intangible assets.

Disclosure of Cost-Based Information

174. Consistent with paragraph 104 of this Paper, if a cost-based model is adopted, the disclosure principles for other types of assets measured in accordance with a cost-based model could be adopted for planned internally generated intangible assets. IAS 16 contains pertinent principles/guidance that may be relevant to internally generated intangible assets. In relation to self-constructed property, plant and equipment, sub-paragraph 74(a) of IAS 16 states that the financial statements shall disclose:

> the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction.

175. The users (financial analysts) and one of the large accounting firms interviewed indicated that the amount of resources spent on internally generated intangible assets is important for evaluating the performance of management. The users noted that it is unclear from the financial reports how much management has spent on particular intangible assets or intangible assets generally because ‘bad outcomes’ are obscured by being written off to the profit or loss and are not generally disclosed. Accordingly, where provided on a project or individual item basis, cost information enables users to monitor the success rate of an entity’s spending in relation to planned internally generated intangible assets over time.

176. As noted in paragraph 32 of this Paper, a single project could give rise to a number of identifiable internally generated intangible assets. Furthermore, some of these assets may not have been anticipated at the commencement of the project. In turn, this may cause the interim and ultimate unit of account to change over the course of the project. Accordingly, if a cost-based model is adopted, the amount of expenditures reliably attributable to each originally or subsequently planned asset should be disclosed.

Conclusion

177. *This Chapter concludes that, if a cost-based model is adopted, the costs relating to the period and reliably attributable to a planned internally generated intangible asset should be disclosed. Arguably, the accumulated costs that are reliably attributable should also be disclosed.*

Disclosure of Reasons for Capitalising Expenditures

178. Lev (2001) argues that while all investments and assets are risky in an uncertain business environment, the riskiness of intangibles is, in general, substantially higher than that of physical and financial assets.

> For one, the prospects of a total loss common to many innovative activities, such as a new drug development or an Internet initiative, are very rare for physical or financial assets. Even highly risky physical projects, such as commercial property, rarely end up as a total loss. The huge Canary Wharf project in London, for example, virtually bankrupt in the mid 1990's, revived later and is now considered a commercial success.
>
> A comparative study of the uncertainty associated with R&D and that of property, plant and equipment confirms the large risk differentials: The earnings volatility (a measure of risk) associated with R&D is, on average, three times larger than the earnings volatility associated with physical investment. (page 39)

179. A number of interviewees noted that some users appear to treat information disclosed in the notes the same as information disclosed on the face of the financial statements. While such reactions seem to be at odds with the characteristics of items that fail the recognition criteria identified in paragraph 83 of the *Framework*, and contradict studies that found information disclosed as supplementary notes is given less weight by users making decisions than

information recognised on the face of the financial statements,[28] it may be that some users have little appreciation of the differences between an internally generated intangible item recognised on the face of the financial statements and an equivalent item disclosed in the notes to the financial statements. Alternatively, it may be that users regard all intangible assets as inherently risky, irrespective of whether they are recognised on the face of the financial statements or disclosed in the notes. Furthermore, because IAS 38 currently prohibits entities from recognising a number of different types of intangible assets, users have limited access to information in relation to intangible assets and, therefore, do not discriminate against information disclosed in the notes. Consistent with this, the users (financial analysts) interviewed noted that if all expenditures in relation to intangible assets are disclosed, they do not require expenditures in relation to internally generated intangible assets to be capitalised. Nevertheless, where costs are capitalised, financial analysts regard management's rationale for capitalisation as useful information.

180. It is relevant to note that IFRS 6, which deals with accounting practices for assets that are arguably analogous to capitalised research and development costs, requires entities to provide additional information in relation to exploration and evaluation assets recognised on the face of the financial statements. Paragraph 23 and sub-paragraph 24(a) of IFRS 6 state that:

> 23 An entity shall disclose information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources.
>
> 24 To comply with paragraph 23, an entity shall disclose:
> (a) its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets….

Conclusion

181. This Chapter concludes that, if a cost-based model is adopted, entities should disclose the reasons for capitalising expenditures reliably attributable to a planned internally generated intangible asset.

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[28] For instance, as noted in footnote 57 in the Management Commentary Discussion Paper (2005), Sami, H. and B. Schwartz (1992), 'Alternative pension liability disclosure and the effect on credit evaluation: an experiment', *Behavioral Research in Accounting*, Volume 4, pp.49-62.

Implications for current requirements

182. IAS 38 does not currently require entities to disclose the reasons for capitalising expenditures. Implementation of this view would therefore require IAS 38 to be amended to require entities to disclose their reasons for capitalising expenditures reliably attributable to a planned internally generated intangible asset.

Valuation-Based Model

Descriptors for Unplanned Internally Generated Intangible Assets

183. The notion that the descriptor adopted for the purpose of financial reporting should depict the item's economic phenomena and be meaningful in its commonly understood way should apply to all recognised internally generated intangible assets, irrespective of whether they are planned or unplanned. Accordingly, descriptors that include the term 'capitalised' would be inappropriate for the purpose of presentation of unplanned internally generated intangible assets in a valuation-based model because 'capitalised' is cost-based terminology. Consistent with the conclusion in paragraph 50 of this Paper, the principles in applying IFRS 3 should be applied in determining appropriate descriptors.

Disclosure of Basis of Measurement

184. Neither IFRS 3 nor IAS 38 specifically requires acquirers to disclose the basis on which they determine the fair values of acquirees' identifiable assets. Therefore, the level of disclosures in relation to fair value measurements required by IFRS 3 and IAS 38 are markedly less onerous than equivalent disclosure requirements in other relevant IASB standards that contain pertinent principles and/or guidance, such as IAS 16 and IAS 40. For instance, paragraph 77 of IAS 16 states that:

> If items of property, plant and equipment are stated at revalued amounts, the following shall be disclosed:
> (a) the effective date of the revaluation;
> (b) whether an independent valuer was involved;
> (c) the methods and significant assumptions applied in estimating the items' fair values;
> (d) the extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques…

185. Similarly, sub-paragraphs 75(d) and (e) of IAS 40 require an entity to disclose:

> (d) the methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily based on other factors (which the entity shall disclose) because of the nature of the property and lack of comparable market data.
>
> (e) the extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. If there has been no such valuation, that fact shall be disclosed.

186. It is relevant to note that the requirements in IAS 16 and IAS 40 are consistent with recent recommendations made by the CFA Institute regarding the disclosure of principles used for measuring intangible assets for the purpose of financial reporting. For instance, in outlining investor needs generally, the CFA Institute[29] recommends that managers disclose:

> …the principles used for recognition and measurement of intangible assets recorded in the financial statements, especially relating to research and development and other project-related activities (page 59).

187. It is also relevant to note that the requirements in IAS 16 and IAS 40 are consistent with disclosure requirements in SFAS 157. SFAS 157 requires, amongst other things, the disclosure of information that enables users to assess the inputs used to measure assets at fair value, either on a recurring or nonrecurring basis. For instance, in relation to assets measured at fair value on a non-recurring basis, sub-paragraphs 33(b) and (c) of SFAS 157 state that:

> (b) The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets…(Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)
>
> (c) For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs…

188. As noted in paragraph 135 of this Paper, where fair values are provided in the financial reports, there appears to be healthy scepticism among financial analysts regarding the veracity of those values. Accordingly, the financial analysts interviewed suggested that, where fair values are provided, they should be supported by the disclosure of information about the measurement model adopted, together with key assumptions and sensitivities. They considered this would

[29] CFA Institute – *A Comprehensive Business Reporting Model* (24 October 2005), CFA Centre for Financial Market Integrity, Charlottesville, Virginia (Referred to in this Chapter as CFA Institute (2005)).

improve the transparency of financial statements and permit users to make more informed decisions regarding managements' assumptions.

189. As discussed in paragraph 167 of this Paper, paragraphs 113 and 116 of IAS 1 currently require entities to disclose information in relation to the accounting policies adopted and judgements made by management that would assist users in understanding the entity's reported financial performance and financial position. Equivalent disclosure principles appear to underlie sub-paragraph 27(c) of IFRS 7, which states, in part, that:

> An entity shall disclose … whether the fair values recognised or disclosed in the financial report are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (i.e. without modification or repackaging) and not based on available observable market data. For fair values that are recognised in the financial report, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the entity shall state this fact and disclose the effect of those changes.

Conclusion

190. *This Chapter concludes that, where an internally generated intangible asset is measured at fair value, the methods and significant assumptions applied in determining the asset's fair value, including the extent to which the asset's fair value was determined directly by reference to observable prices or was estimated using other valuation techniques, should be disclosed. In addition, if changing one or more of the assumptions used to determine the fair value to reasonably possible alternative assumptions would change the fair value significantly, the entity should state this fact and disclose the effect of those changes.*

191. Information relating to the methods and significant assumptions applied in determining the fair value of an internally generated intangible asset could include:

(a) the effective date of the measurement; and

(b) whether an independent valuer was involved in determining the fair value measurement.

Disclosures of Alternative Measures

192. Sub-paragraph 77(e) of IAS 16 requires the following to be disclosed:

> …for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model…

Consistent with this, in relation to intangible assets measured after recognition using the revaluation model, sub-paragraph 124(a)(iii) of IAS 38 requires entities to disclose:

> …the carrying amount that would have been recognised had the revalued class of intangible assets been measured after recognition using the cost model in paragraph 74.

193. While some argue that the disclosure of alternative measures for items recognised on the face of the financial statements could mislead or confuse users, it is evident from the disclosure requirements in IAS 16 and IAS 38 that this is not anticipated in relation to internally generated tangible assets or intangible assets separately acquired or acquired in business combinations. As all assets have the same fundamental characteristics as identified in paragraph 49(a) of the *Framework*, it would seem reasonable to assume, therefore, that users would regard information in relation to the cost of developing an internally generated intangible asset as useful for similar reasons as they would regard information in relation to the cost of developing an internally generated tangible asset as useful, or the cost of intangible assets measured using the revaluation model in IAS 38 as useful. Furthermore, consistent with paragraph 177 of this Paper, the cost reliably attributable to each recognised internally generated intangible asset should be disclosed.

Interviewees' Perspectives

194. The users (financial analysts) interviewed noted that their principal focus in relation to internally generated intangible assets is on cash flows. Accordingly, the users indicated that, irrespective of the measurement method used for intangible assets, they would prefer entities to disclose expenditures in relation to intangible assets, distinguishing between capital/expansionary expenditure and operating/maintenance expenditure, whether on an aggregate or on a project-by-project basis. The users indicated that cost information is necessary for them to make their own assessments of value.

Conclusion

195. This Chapter concludes that, where internally generated intangible assets are measured at fair value, the costs reliably attributable to an internally generated intangible asset should be disclosed.

Disclosure of Provisional Measures

196. As discussed in paragraph 129 of this Paper, where an internally generated intangible asset satisfies the relevant definition and recognition criteria at the reporting date, typically its final fair value would be available. However, in the rare circumstances where this is not the case, consistent with the provisional accounting principles in IFRS 3, the internally generated intangible asset should be measured initially on a provisional basis rather than not measured at all. Accordingly, if an internally generated intangible asset is measured provisionally in accordance with the principles underlying paragraphs 61 and 62 of IFRS 3, the principles underlying the disclosure requirements in paragraph 69 of IFRS 3 should also apply to the internally generated intangible asset. Paragraph 69 of IFRS 3 states that:

> If the initial accounting for a business combination that was effected during the period was determined only provisionally as described in paragraph 62, that fact shall also be disclosed together with an explanation of why this is the case.

Conclusion

197. This Chapter concludes that, where an internally generated intangible asset is measured provisionally at balance date, that fact should be disclosed together with an explanation of why this is the case.

DISCLOSURE TO SUPPLEMENT NON-RECOGNITION DUE TO FAILURE TO SATISFY RECOGNITION CRITERIA

198. Whether information about an item that does not meet the relevant recognition criteria under a cost-based model or a valuation-based model is disclosed in a financial report may be regarded as a matter for professional judgement in the particular circumstances. For instance, paragraph 21 of the *Framework* states that:

> Financial reports also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement. They may include disclosures about the risks and uncertainties affecting the entity and any resources and obligations not recognised in the balance sheet (such as mineral reserves).

199. Use of the word 'may' in paragraph 21 of the *Framework* could arguably be interpreted to mean that, subject to the qualitative characteristics identified in paragraphs 27 to 46 of the *Framework*, entities can choose not to disclose information in relation to items that do not satisfy the relevant recognition criteria in their financial reports if they believe the information is not useful for users.

200. In relation to intangible assets acquired in business combinations, paragraph 67(h) of IFRS 3 states that for each business combination the acquirer shall disclose, where relevant:

> …a description of each intangible asset that was not recognised separately from goodwill and an explanation of why the intangible asset's fair value could not be measured reliably…

Some argue that the principles underlying the requirements in sub-paragraph 67(h) of IFRS 3 are only relevant to business combinations. In particular, the description of each intangible asset not recognised separately from goodwill provides users with information useful to understanding the cost of the business combination. However, as discussed in paragraph 79 of this Paper, this type of rationale is not relevant to the identification of internally generated intangible assets because internally generated goodwill is not recognised.

201. Sub-paragraph 128(b) of IAS 38 states that:

> An entity is encouraged, but not required, to disclose the following information:
>
> (a) …
>
> (b) a brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria in this Standard or because they were acquired or generated before the version of IAS 38 *Intangible Assets* issued in 1998 was effective.

While sub-paragraph 67(h) of IFRS 3 and sub-paragraph 128(b) of IAS 38 appear to be aimed at achieving similar financial reporting outcomes, where relevant, the application of sub-paragraph 67(h) of IFRS 3 is mandatory whereas the application of sub-paragraph 128(b) of IAS 38 is not.

Interviewees' Perspectives

202. An interviewee from one of the four large accounting firms noted that while the users of financial reports might welcome note disclosures in relation to internally generated intangible assets that do not fulfil the relevant recognition criteria, reporting entities do not generally share this view. The interviewee suggested that, if an internally generated intangible asset does not fulfil the recognition criteria, given the choice between disclosing the item in the notes and not disclosing it at all, management and directors would invariably favour the latter course of action. This preference could be attributed to a number of factors, including the unfavourable reactions associated with users' unfulfilled expectations in relation to items disclosed in the notes, and the general perception amongst managers and directors that information recognised on the face of the financial statements is relatively more useful than information disclosed in the notes.

203. An independent valuation expert interviewed commented that, considering the emphasis now being put on intangible assets, note disclosures about intangible assets that do not fulfil the relevant recognition criteria do not serve users particularly well and are an inadequate means of ensuring that capital markets are fully informed.

Conclusion

204. This Chapter concludes that, in each period when an internally generated intangible asset does not meet the relevant recognition criteria, whether under a cost-based model or a valuation-based model, entities should provide a description of the asset and the reason why the asset fails to meet the relevant recognition criteria.

SECTION 2: INITIAL ACCOUNTING FOR SEPARATELY PURCHASED INTANGIBLE ASSETS

CHAPTER 6: INITIAL MEASUREMENT OF SEPARATELY PURCHASED INTANGIBLE ASSETS

[under development as at January 2007]

SECTION 3: SUBSEQUENT ACCOUNTING FOR INTANGIBLE ASSETS

CHAPTER 7: SUBSEQUENT MEASUREMENT OF INTANGIBLE ASSETS

[work is yet to commence as at January 2007]

APPENDIX A
INTERVIEWS

A1. As noted in paragraph 4 of the Paper, constituents with past experience in identifying, recognising, measuring and remeasuring internally generated intangible assets and using the resulting information were interviewed by the project staff for the purpose of the project. Fourteen interviews were conducted. Interviewees were people who had experience with Accounting Standards that permitted recognition and measurement (and/or remeasurement) of internally generated intangible assets in a broader range of circumstances than under IFRS 3 and IAS 38[30] and with using the resulting information. Appropriate constituents with relevant experience were identified, in the first instance, through the Australian 'Group of 100'.[31] Interviews were also conducted with Australian representatives of the 'Big-4' large accounting firms. The interviewees were assured confidentiality and therefore views have not been attributed to particular interviewees. The interviewees have been categorised on the following basis for the purposes of this Paper:

(a) Large accounting firms;

(b) Consumer product corporations;

(c) Financial services corporations;

(d) Telecommunication and broadcasting corporations;

(e) Users of financial reports[32]; and

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30 All the interviewees had experience in the Australian environment when the Accounting Standards allowed internally generated intangible assets to be recognised in a wide range of circumstances and measured on either a cost or fair value basis.

31 The Australian 'Group of 100' represents Australia's senior financial executives from the nation's major private and public business enterprises. The primary goal of the organisation is to ensure that Australia's commercial environment is one that advances the interests of Australian businesses engaged in the competitive global environment (www.group100.com.au).

32 Interviewees categorised as 'users of financial reports' were employed as securities and equities analysts.

(f) Independent valuation experts[33].

For the purposes of confidentiality, given the small number of entities in each category, the entities whose management and accounting staff were interviewed are not specifically identified.

A2. Representatives of the entities selected were interviewed by project staff using a series of open-ended questions regarding the participants' experiences with respect to the identification, recognition and measurement (and remeasurement) of intangible assets, particularly internally generated intangible assets. Particular emphasis was placed on the reliability of measurement procedures being employed prior to the adoption of IFRS 3 and IAS 38. Most initial interviews took between 1 and 1 ½ hours to complete, although a small number of initial interviews lasted for approximately 2 hours.

A3. The following questions (provided to interviewees prior to the interviews) provided the basis of the project staff's discussions with interviewees about initial recognition of internally generated and separately acquired intangible assets from the large accounting firms, consumer product corporations, financial services corporations, telecommunications and broadcasting corporations.

(a) Internally generated intangible assets:

(i) What types of internally generated intangible assets has your organisation identified and recognised in the past under Australian Accounting Standards?

(ii) Are there other types of internally generated intangible assets that you believe should have been separately identified and recognised?

(iii) What are the characteristics of those internally generated intangible assets that you believe should be separately identified and recognised that distinguishes them from other (unrecognised) internally generated intangible assets and internally generated goodwill?

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[33] Project staff spoke to two independent valuation experts, both from the same firm.

(iv) What are the benefits of separately identifying and recognising the types of internally generated intangible assets addressed in questions (i) and (ii) above?

(v) What measurement techniques have you used for initial recognition of each type of internally generated intangible asset?

(b) Separately acquired intangible assets:

(i) What types of intangible assets has your organisation separately acquired?

(ii) What measurement techniques have you used for initial recognition of each type of separately acquired intangible asset?

(iii) What measurement techniques have you used subsequent to initial recognition?

Project staff rephrased some questions when interviewing entities in accordance with the interviewee's specific circumstances. For instance, the question 'What types of internally generated intangible assets has your organisation identified and recognised in the past under Australian Accounting Standards?' was modified to 'What types of internally generated intangible assets have you had experience with in the past under Australian Accounting Standards?' when interviewing representatives of large accounting firms.

A4. The following questions (provided to interviewees prior to the interviews) provided the basis of the project staff's discussions with the users of financial reports and independent valuation experts about internally generated intangible assets:

(a) What types of internally generated intangible assets have you encountered prior to the introduction of IFRSs?

(b) What characteristics did those internally generated intangible assets identified in (a) above exhibit that led you to regard them as separately identifiable from internally generated goodwill?

(c) What are the benefits of separately identifying the types of internally generated intangible assets that possess the characteristics identified in (b) above?

(d) For those internally generated intangible assets that you separately measure/value, what measurement/valuation techniques have you used:

  (i) quoted prices for identical assets in active markets;

  (ii) quoted prices for identical assets in non-active markets;

  (iii) quoted prices for similar assets in active markets;

  (iv) other observable market inputs such as:

  - measures of volatility;
  - inputs derived from or corroborated by other observable market data through correlation, extrapolation or interpolation;

  (v) unobservable market inputs, using assumptions that market participants would use in pricing the assets, such as future cash flows;

  (vi) other measurement techniques such as historical or replacement cost?

(e) Are you aware of any new or developing markets for particular types of internally generated intangible assets that might assist you in initially measuring/valuing internally generated intangible assets? If so, what characteristics would a new/developing market need to exhibit for you to regard it as capable of generating reliable prices for measurement/valuation purposes?

All of the users of financial reports and independent valuation experts interviewed were asked to respond to questions (a), (d) and (e), whereas only the independent valuation experts were asked to respond to questions (b) and (c). The users of

financial reports were not asked to respond to questions (b) and (c) because they confirmed that they had no direct involvement in the preparation of the financial reports that they used to value businesses and/or the equity instruments of businesses and their knowledge of specific internally generated intangible assets was, for the purpose of the interviews, limited to disclosures made in published financial reports.

A5. Although the interviews conducted involved a range of entities with diverse experiences regarding intangible assets, many of the interviewees expressed similar views on a number of issues related to internally generated intangible assets, including:

(a) Intangible assets are an important component of business operations and represent an increasing proportion of businesses' assets.

(b) Entities have experience in measuring the fair value[34] of a range of internally generated intangible assets, including brand names, mastheads and customer contracts, being those that are protectable/transferable. Some have not been recognised, but could be reliably measured, such as management rights. One comment made was that reliable measurement is not dependent on a transaction, because a transaction represents only one opinion of value at a single point in time.

(c) Reliable measurement is particularly achievable where an internally generated intangible asset has traceable cash flows. Cost is not a good indicator of value, but may be a basis for initial measurement and, subject to impairment, subsequent measurement.

(d) The 'relief from royalties' method is the most broadly accepted method in practice amongst preparers, auditors and independent valuation experts for determining a reliable measure of fair value of certain internally generated intangible assets, such as brand names. Users of financial reports, on the

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[34] The interviews did not focus on the definition of fair value. The Australian Accounting Standards under which the interviewees had experience in recognising internally generated intangible assets defined fair value as "the amount for which an asset could be exchanged … between knowledgeable, willing parties in an arm's length transaction." (paragraph 9.1 of AASB 1041 *Revaluation of Non-Current Assets*).

other hand, did not express a preference for any particular measurement method. They were more interested in accounting treatments being applied consistently across all intangible assets and/or reporting entities and the methodology adopted. They were also interested in reporting entities disclosing the key assumptions underlying the measurements of intangible assets recognised or disclosed in their financial reports. Users of financial reports also expressed a preference for cash flow information, particularly cash expenditure, whether on an aggregate or project-by-project basis, over asset valuation information.

(e) For some items it can be difficult to ensure that the value attributable to the item excludes value attributable to other phenomena.

(f) Certain items cannot be reliably measured/separated from goodwill, such as the corporate brand and assembled workforce.

(g) Concern about the inconsistencies in the financial reporting treatment of intangible assets acquired in a business combination as compared with internally generated intangible assets. However, there was acknowledgement that a business combination at least provides a strong indication of an upper limit for valuation purposes.

(h) There are practical factors that influence an entity's attitude to recognition and measurement of internally generated intangible assets. For instance, the treatment of some items by domestic regulators (eg the Australian Prudential Regulation Authority); the treatment of some items for tax purposes; the effects of banking covenants; implications for performance reporting; and the desire for prudent measures.

(i) Note disclosure as an alternative to recognition may have some merit or represent a reasonable compromise, however it is difficult to justify conceptually.

The results of the interviews are reflected as accurately as possible throughout this Paper. The Paper focuses on a critical analysis of the main issues relating to the

initial accounting for internally generated intangible assets, rather than a critical analysis and assessment of interviewees' comments.

APPENDIX B
THE DEFINITION OF AN ASSET AND PLANNED AND UNPLANNED INTERNALLY GENERATED INTANGIBLE ITEMS

INTRODUCTION

B1. This Appendix provides an analysis of the two main types of internally generated intangible items (planned and unplanned) to assess the circumstances under which they satisfy the elements of the definition of assets: past event, expected future economic benefits and control.

PLANNED INTERNALLY GENERATED INTANGIBLE ASSETS

Past Event

B2. Arguably, the incurrence of attributable costs is a relevant past event for the purpose of contributing towards satisfying the definition of an asset and provides a context for identifying the asset. The incurrence of costs is arguably even more relevant than a business combination as a context for identifying intangible assets to the extent that a business combination involves the disaggregation of an amount to its components rather than the allocation of attributable amounts to an aggregate.

Expected Future Economic Benefits

B3. The fact that an entity incurs attributable costs in implementing its plan for a project, the primary purpose of which is to create an intangible asset, implies that there is an expectation of future economic benefits. This reasoning is consistent with IFRS 3. Under IFRS 3, an acquirer's decision to incur costs in excess of the net fair value of its interest in the acquiree's identifiable assets, liabilities and contingent liabilities is regarded as sufficient proof that future economic benefits associated with the excess (goodwill) are expected to flow to the acquirer.

B4. If future costs are expected to exceed the gross future economic benefits prior to the commencement of a specific planned project, it is reasonable to assume that the project would not be commenced. It would be expected to be rejected in the

feasibility/capital budgeting phase. Presumably it would only be commenced if it were expected to be successful.

B5. The definition of an asset does not specify that the expected future economic benefits referred to in the definition must equal or exceed the costs incurred. Given the nature of planned internally generated intangible items, it is arguable that, even where the future economic benefits are not expected to equal or exceed the costs, an asset may exist (for example, in the form of knowledge that a research and development project undertaken did not produce a net positive outcome).[35] If a plan to create an intangible asset is found to be 'unsuccessful', which would only be known at the point of abandonment of the project, the knowledge that the line of enquiry was unsuccessful would satisfy the expected future economic benefits aspect of the definition of an asset. The future economic benefits associated with the knowledge is that, having incurred the costs, the entity will be able to avoid future costs that would otherwise be incurred to pursue the same line of investigation (paragraph 53 of the *Framework* states: "The future economic benefit embodied in an asset … may … take the form of … a capability to reduce cash outflows …").[36] It is also possible that the entity could sell the knowledge to another entity that wants to avoid incurring costs known to be 'unproductive'. In support of this view, it is relevant to note that paragraph 57 of the *Framework* states:

> … know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

B6. In contrast to the view expressed in paragraph B4, some argue that in applying the definition of an asset, particularly in a cost-based model, the question to be answered is whether a transaction (incurring costs in relation to a project) gives

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35 Work on the definition of assets for the purposes of the IASB/FASB Conceptual Framework project supports this conclusion. Paragraph 19 of a paper *Information for Observers* provided at the 26 April 2006 IASB meeting relating to the project *Conceptual Framework: Elements 4: Asset Definition (III) & Liability Definition (II) (Agenda Paper 8A)* states: "As long as there is a non-zero probability or expectation of economic benefit to the entity at the financial statement date, then the entity has an economic resource."

36 Grossman G and Helpman E ("Endogenous Innovation in the Theory of Growth", *Journal of Economic Perspectives*, 1994, Vol. 8, pages 23 - 44) note that: "Knowledge is cumulative, with each idea building on the last... In that sense, every knowledge-orientated dollar makes a productivity contribution on the margin…." (page 31)

rise to future economic benefits. They argue that, because the transaction has two sides (an outflow and a related potential future inflow of economic benefits), it should be considered from a net perspective – and that only an expected net positive inflow can give rise to an asset (albeit possibly measured at cost).

B7. Consistent with the view that is emerging in the IASB/FASB Conceptual Framework project, expectation of a gross (positive) inflow is sufficient for an asset to arise/continue to exist. By the nature of planned internally generated intangible items, there is an expectation of future economic benefits irrespective of whether the knowledge was acquired from a 'successful' or 'unsuccessful' project. Under this approach, the impact of an expected (negative) net outflow is treated as an impairment/measurement issue rather than as a definition (or recognition) issue.

B8. In concept, a consequence of this view is that amounts representing what would otherwise be losses may give rise to an intangible asset of an entity to the extent they are incurred in implementing a specific planned project (and the knowledge that the project was unsuccessful) is kept secret. Even in the limited circumstances where it would be conceptually justifiable to capitalise the losses in practice, that would only occur to the extent they are attributable to an identifiable asset (for example, secret know-how) and would be subject to recoverability/fair value measurement.

Control

B9. In circumstances where a planned internally generated intangible item will not be controlled by the entity (for example, because knowledge acquired from a research and development or other planned project, whether successful or unsuccessful, is not expected to be kept secret or otherwise protected) an asset does not exist.[37] In the absence of legal control, an entity might be limited in its

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[37] Lev (2001) notes on page 83 that a unique characteristic of intangible assets is partial excludability (inability to exclude non-owners from enjoying some benefits), which may lead to a conclusion of lack of control. There is limited guidance on the meaning of control in the *Framework*. However, it is apparent from the examples of intangible assets referred to in the *Framework* (patents, copyrights, know-how kept secret) and in IFRS 3 (see paragraph 20 of Chapter 2 of this Paper) that control is not defined as narrowly as contemplated by Lev.

capacity to exclude others from capturing some or all of the benefits associated with a specific planned project intended to create an asset.

B10. Some express concern that treating planned internally generated intangible items as assets could result in spurious costs being capitalised to research the obvious (for example, researching the cancer curing properties of water and then claiming that an asset exists when no cancer curing properties are found). However, such practice is unlikely to be economically rational. Furthermore, arguably, although undertaken through a specific planned project, the outcome is generally known and therefore, in concept, is not controlled because it is not secret know-how. Furthermore, impairment testing should ensure that inappropriately recognised costs are de-recognised.

B11. Treating planned internally generated intangible items that satisfy the elements of the definition of an asset as assets is consistent with the approach in IFRS 3. For example, paragraph 45 of IFRS 3 anticipates that an in-process research and development project acquired in a business combination may meet the definition of an intangible asset. Similarly, the Illustrative Examples that accompany IFRS 3 anticipate many types of planned intangible assets internally generated by an acquiree that are subsequently acquired by an acquirer in a business combination meeting the definition of an intangible asset.

UNPLANNED INTERNALLY GENERATED INTANGIBLE ASSETS

Past Event

B12. Paragraph 58 of the *Framework* makes it clear that incurrence of cost, let alone incurrence of attributable costs, is not necessary for an asset to exist:

> The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets; examples include property received by an entity from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits …

Arguably, by analogy with the discovery of mineral deposits, ‘discovery’ of or identification that or becoming aware that, for example, a brand has been developed out of the day-to-day operations of a business is a relevant past event. However, it is acknowledged that discovery of mineral deposits has traditionally

been accounted for on a cost attribution basis, which is more akin to planned internally generated intangible assets.

Expected Future Economic Benefits and Control

B13. In the absence of a specific planned project with attributable costs, even if it is accepted that a relevant past event has occurred, there is less of a context for identification and arguably less of a basis for forming an expectation of future economic benefits and asserting that control exists. However, to the extent that IFRS 3 acknowledges that an item that arose from the day-to-day operations of an acquiree prior to a business combination can meet the definition of an intangible asset in a business combination, the same rationale can apply even in the absence of a business combination. To create a context, as contemplated in paragraph 40 of this Paper, a technique such as a hypothetical business combination could be adopted whereby the entity is assumed to be an acquiree as at the reporting date at least for the purpose of identifying unplanned internally generated intangible assets.

B14. Some argue that although unplanned internally generated intangible assets exist and can be identified conceptually, there is no practical way of identifying them separately from goodwill because there is no event (control point) to justify separate identification, except the advent of reporting date. They express concern that because the only trigger for identification is reporting date this may result in ongoing fair valuation, which would be onerous. This is related to the question of recognition and is discussed in that context in Chapter 3 of this Paper.

APPENDIX C
EXTRACT FROM BASIS FOR CONCLUSIONS ACCOMPANYING IFRS 3 RELATING TO THE PRESUMPTION OF RELIABLE MEASUREMENT

The following extract from the Basis for Conclusions accompanying IFRS 3 relating to recognition criteria articulates the debate surrounding whether to specify a non-rebuttable presumption of fair value reliable measurement for intangible assets acquired in a business combination.

BC97 In developing ED 3 and the IAS 38 Exposure Draft, the Board had concluded that, except for an assembled workforce, sufficient information could reasonably be expected to exist to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity. Respondents generally disagreed with this conclusion, arguing that:

(a) it might not always be possible to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity.

(b) a similar presumption does not exist in IFRSs for identifiable tangible assets acquired in a business combination. Indeed, the Board decided when developing the IFRS to carry forward from IAS 22 the general principle that an acquirer should recognise separately from goodwill the acquiree's identifiable tangible assets, but only provided they can be measured reliably.

BC98 Additionally, as part of its consultative process, the Board conducted field visits and round-table discussions during the comment period for the Exposure Draft.* Field visit and round-table participants were asked a series of questions aimed at improving the Board's understanding of whether there might exist non-monetary assets without physical substance that are separable or arise from legal or other contractual rights, but for which there may *not* be sufficient information to measure fair value reliably.

* The field visits were conducted from early December 2002 to early April 2003, and involved IASB members and staff in meetings with 41 companies in Australia, France, Germany, Japan, South Africa, Switzerland and the United Kingdom. IASB members and staff also took part in a series of round-table discussions with auditors, preparers, accounting standard-setters and regulators in Canada and the United States on implementation issues encountered by North American companies during first-time application of US Statements of Financial Accounting Standards 141 *Business Combinations* and 142 *Goodwill and Other Intangible Assets*, and the equivalent Canadian Handbook Sections, which were issued in June 2001.

BC99 The field visit and round-table participants provided numerous examples of intangible assets they had acquired in recent business combinations whose fair values might not be reliably measurable. For example, one participant acquired water acquisition rights as part of a business combination. The rights are extremely valuable to many manufacturers operating in the same jurisdiction as the participant—the manufacturers cannot acquire water and, in many cases, cannot operate their plants without them. Local authorities grant the rights at little or no cost, but in limited numbers, for fixed periods (normally 10 years), and renewal is certain at little or no cost. The rights cannot be sold other than as part of the sale of a business as a whole, therefore there exists no secondary market in the rights. If a manufacturer hands the rights back to the local authority, it is prohibited from reapplying. The participant argued that it could not value these rights separately from its businesses (and therefore from the goodwill), because the businesses would cease to exist without the rights.

BC100 After considering respondents' comments and the experiences of field visit and round-table participants, the Board concluded that, in some instances, there might not be sufficient information to measure reliably the fair value of an intangible asset separately from goodwill,

notwithstanding that the asset is 'identifiable'. The Board observed that the intangible assets whose fair values respondents and field visit and round-table participants could not measure reliably arose either:

(a) from legal or other contractual rights and are not separable (ie could be transferred only as part of the sale of a business as a whole); or

(b) from legal or other contractual rights and are separable (ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability), but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on variables whose effect is not measurable.

BC101 Nevertheless, the Board remained of the view that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill, particularly given the Board's decision to regard goodwill as an indefinite-lived asset that is not amortised. The Board also remained concerned that failing the reliability of measurement recognition criterion might be inappropriately used by entities as a basis for not recognising intangible assets separately from goodwill. For example, IAS 22 and the previous version of IAS 38 required an acquirer to recognise an intangible asset of the acquiree separately from goodwill at the acquisition date if it was probable that any associated future economic benefits would flow to the acquirer and the asset's fair value could be measured reliably. The Board observed when developing ED 3 that although intangible assets constitute an increasing proportion of the assets of many entities, those acquired in business combinations were often included in the amount recognised as goodwill, despite the requirements in IAS 22 and the previous version of IAS 38 that they should be recognised separately from goodwill.

BC102 Therefore, although the Board decided not to proceed with the proposal that, with the exception of an assembled workforce, sufficient information should always exist to measure reliably the fair value of an intangible asset acquired in a business combination, the Board also decided:

(a) to clarify in IAS 38 that the fair value of an intangible asset acquired in a business combination can normally be measured with sufficient reliability for it to be recognised separately from goodwill. When, for the estimates used to measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities, that uncertainty enters into the measurement of the asset's fair value, rather than demonstrates an inability to measure fair value reliably.

(b) to include in IAS 38 a rebuttable presumption that the fair value of a finite-lived intangible asset acquired in a business combination can be measured reliably.

(c) to clarify in IAS 38 that the only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination are when the intangible asset arises from legal or other contractual rights and it either (i) is not separable or (ii) is separable but there is no history or evidence of exchange transactions for the same or similar assets and otherwise estimating fair value would be dependent on variables whose effect is not measurable.

(d) to include in the IFRS a requirement for entities to disclose a description of each asset that meets the definition of an intangible asset and was acquired in a business combination during the period but was not recognised separately from goodwill, and an explanation of why its fair value could not be measured reliably.

BC103 Some respondents and field visit participants suggested that it might also not be possible to measure reliably the fair value of an intangible asset when it is separable, but only together with a related contract, asset or liability (ie it is not individually separable), there is no history of exchange transactions for the same or similar assets on a stand-alone basis, and, because the related items produce jointly the same cash flows, the fair value of each could be estimated only by arbitrarily allocating those cash flows between the two items. The Board disagreed that such circumstances provide a basis for subsuming the value of the intangible asset within the carrying amount of goodwill. Although some intangible assets are so closely related to other identifiable assets or liabilities that they are usually sold as a 'package', it would still be possible to measure reliably the fair value of that 'package'. Therefore, the Board decided to include the following clarifications in IAS 38:

(a) when an intangible asset acquired in a business combination is separable but only together with a related tangible or intangible asset, the acquirer recognises the group of assets as a single asset separately from goodwill if the individual fair values of the assets in the group are not reliably measurable.

(b) similarly, an acquirer recognises as a single asset a group of complementary intangible assets constituting a brand if the individual fair values of the complementary assets are not reliably measurable. If the individual fair values of the complementary assets are reliably measurable, the acquirer may recognise them as a single asset separately from goodwill, provided the individual assets have similar useful lives.

BC104 As noted in paragraph BC90, the Board also considered whether the criteria for recognising intangible assets separately from goodwill should also be applied to in-process research and development projects acquired in a business combination, and concluded that they should. In reaching this conclusion, the Board observed that the criteria in IAS 22 and the previous version of IAS 38 for recognising an intangible asset acquired in a business combination separately from goodwill applied to all intangible assets, including in-process research and development projects. Therefore, the effect of those Standards was that any intangible item acquired in a business combination was recognised as an asset separately from goodwill when it was identifiable and could be measured reliably, and it was probable that any associated future economic benefits would flow to the acquirer. If those criteria were not satisfied, the expenditure on that item, which was included in the cost of the combination, was attributed to goodwill.

BC105 The Board could see no conceptual justification for changing the approach in IAS 22 and the previous version of IAS 38 of using the same criteria for all intangible assets acquired in a business combination when assessing whether those assets should be recognised separately from goodwill. The Board concluded that adopting different criteria would impair the usefulness of the information provided to users about the assets acquired in a combination, because both comparability and reliability would be diminished.

BC106 Some respondents to ED 3 and the IAS 38 Exposure Draft expressed concern that applying the same criteria to all intangible assets acquired in a business combination to assess whether they should be recognised separately from goodwill results in treating some in-process research and development projects acquired in business combinations differently from similar projects started internally. The Board acknowledged this point. However, it concluded that this does not provide a basis for subsuming those acquired intangible assets within goodwill. Rather, it highlights a need to reconsider the view taken in IAS 38 that an intangible asset can never exist in respect of an in-process research project and can exist in respect of an in-process development project only once all of the criteria for deferral in IAS 38 have been satisfied. The Board concluded that such a reconsideration is outside the scope of its Business Combinations project.