THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

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LKAS 38 Intangible Assets

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LKAS 38: Overview

- **Objective**
- **Scope**
- **Definitions**
- **Recognition and measurement**
  - Separate acquisition
  - Acquisition in a business combination
  - Internally generated
- **Measurement after acquisition**
- **Disclosure**

LKAS 38: Objective

- **Prescribe the accounting treatment for intangible assets not dealt with specifically in another standard**
- **Requires an entity to recognise an intangible asset if, and only if, specified criteria are met**
- **Specifies how to measure the carrying amount of intangible assets**
- **Requires specified disclosures about intangible assets**

Scope

- **Applied in accounting for intangible assets except**
  - Intangible assets that are within the scope of another standard
    - E.g. Goodwill acquired in a business combination (SLFRS 3)
  - Financial assets (as defined in LKAS 32 *Financial Instruments: Presentation*)
  - Recognition and measurement of exploration and evaluation assets (see SLFRS 6 *Exploration for and Evaluation of Mineral Resources*)
  - Expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources

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Introduction

- **Definitions matter**
  - Is a resource an 'asset'?
  - If yes, is it 'goodwill' or an 'intangible?
    - Different recognition and measurement rules apply to goodwill and other intangibles
      - SLFRS 3 *Business Combinations* covers goodwill arising in a business combination
      - Other intangibles are dealt with by LKAS 38

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Definitions

- **Asset is a resource**
  - **Controlled** by an entity as a result of past events
  - From which **future economic benefits** are expected to flow to the entity
- **Intangible asset**
  - An **identifiable** non-monetary asset without physical substance

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Definitions

- **Identifiable**
  - Asset is identifiable if it is either:
    - Separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, or
    - 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
- **Control over a resource exists where entity has power**
  - To obtain future economic benefits, and
  - To restrict access of others to those benefits
- **Future economic benefits may include revenue from sale of products/services or cost savings**

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Recognition and Measurement

- **Recognise if, and only if:**
  - It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity, and
  - Cost of the asset can be measured reliably
- **Assess probability of expected future economic benefits**
  - Using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset
- **Measure initially at cost**

Recognition and Measurement

- **Exercise**

An entity purchased 3 rights to receive income in the future:

A. The right to receive 25% of the ticket sales of a tennis tournament;

B. The right to operate a "digital hoarding" in a supermarket car park;

C. The right to distribute a branded dairy products.

Which of the above are intangible assets and financial assets?

Recognition and Measurement

Answer

An entity purchased 3 rights to receive income in the future:

A. The right to receive 25% of the ticket sales of a tennis tournament; - **right to receive cash is a financial asset**

B. The right to operate a "digital hoarding" in a supermarket car park; **- right to earn revenue is an intangible asset**

C. The right to distribute a branded dairy products. – **the right to earn revenue is an intangible asset**

Recognition and Measurement

Exercise

Professional football club X enters into the following transactions:

A. It pays LKR500 for the registration of player X, which means that the player can only play for club X.

B. It exchanges the registration of player B which has a fair value of LKR280 to club Y and receives the right to 15% of the ticket sales of club Y for next year. The right to the sales, has a fair value LKR280.

C. It pays LKR150 to have the right to purchase the registration of player C, if his current club get demoted to a lower division this season.

D. It pays LKR80 to Mr. D as a sign on bonus to come and work with the club as a finance director for 5 years. If Mr. D leaves within 5 years, he does not have to pay back the bonus.

How should the club allocate the above amounts between intangible assets and financial assets?

Recognition and Measurement

Answer

Professional football club X enters into the following transactions:

A. It pays LKR500 for the registration of player X, which means that the player can only play for club X. – **intangible asset**

B. It exchanges the registration of player B which has a fair value of LKR280 to club Y and receives the right to 15% of the ticket sales of club Y for next year. The right to the sales, has a fair value LKR280. – **financial asset**

C. It pays LKR150 to have the right to purchase the registration of player C, if his current club get demoted to a lower division this season. **intangible asset**

D. It pays LKR80 to Mr. D as a sign on bonus to come and work with the club as a finance director for 5 years. If Mr. D leaves within 5 years, he does not have to pay back the bonus. – **does not create an asset**

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Acquiring Intangible Assets

- **Intangible assets can be acquired through:**
  - Separate acquisition
  - Acquisition in a business combination, or
  - Internal generation
- **LKAS 38 provides additional recognition guidance for each method of acquisition**

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Separate Acquisition

- **Identifiable attributes**
  - Arises from contractual or other legal rights
- **Control**
  - Obtained through contractual or legal rights
- **Future economic benefits**
  - Implicit in paying a price to acquire
- **Cost**
  - Generally based on cash paid or FV of consideration given; and
  - Includes directly attributable costs of preparing the asset for its intended use

Separate Acquisition

- **Directly attributable costs include**
  - costs of employee benefits arising directly from bringing the asset to its working condition;
  - professional fees arising directly from bringing the asset to its working condition; and
  - costs of testing whether the asset is functioning properly

Separate Acquisition

- **Directly attributable costs exclude**
  - costs of introducing a new product or service (including costs of advertising and promotional activities;
  - costs of conducting business in a new location or with a new class of customer (including costs of staff training);
  - administration and other general overhead costs
  - costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use;
  - Initial operating losses;
  - Interest cost, if payment for an intangible asset is deferred beyond normal credit terms.

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Acquisition in a Business Combination

- **Recognised separately from goodwill if 'identifiable' and meets the recognition criteria**
- **Identifiable if:**
  - Arises from contractual or other legal rights, or
  - Is separable
- **Recognition criteria always considered to be met**
  - Probable flow of economic benefits – implicit in fair value
  - Capable of reliable measurement – if identifiable, sufficient information exists to measure asset's fair value reliably

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Acquisition in a Business Combination

- **Purchased 'in-process research and development'**
  - Capitalise separately from goodwill
    - If project meets definition of an intangible asset, i.e.
      - It meets definition of an asset, and
      - Is identifiable (separable or arises from contractual or other legal rights)
    - Must test for impairment
  - Subsequent expenditure on these projects must be accounted for under LKAS 38’s rules for internally generated intangibles:
    - Expense research costs
    - Capitalise development costs where criteria are met

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Acquisition in a Business Combination

SLFRS 3: Illustrative Examples

- **Marketing-related**
- **Customer-related**
- **Artistic-related**
- **Contract-based**
- **Technology-based**

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Marketing-related Intangibles

Examples

- Trademarks, trade names, certification marks
- Trade dress (unique colour, shape, package design)
- Newspaper mastheads
- Internet domain names
- Non-competition agreements

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Customer-related Intangibles

Examples

- Customer lists
- Order or production backlogs
- Customer contracts and related customer relationships
- Non-contractual customer relationships

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Artistic-related Intangibles

Examples

- Plays, operas, ballets
- Books, magazines, literary works
- Musical works: song lyrics, advertising jingles
- Pictures and photographs
- Video and AV material: motion pictures, films, music videos, television programmes

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Contract-based Intangibles

Examples

- Agreements: consulting, income, licensing, manufacturing, royalty, or standstill
- Contracts: advertising, construction, consulting, customer, employment, insurance, maintenance, management, marketing, mortgage, purchase, service, and supply
- Covenants: non-compete
- Leases: valuable or favourable terms
- Permits: construction
- Rights: broadcasting, development, mineral

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Technology-based Intangibles Examples

- Relates to innovations or technological advances
- Computer software and license, computer programs, information systems, program formats, internet domain names
- Secret formulas, processes, and recipes
- Technical drawings, procedural manuals, and blueprints
- Databases, manufacturing processes, procedures, production lines
- R & D and technological know-how

Acquisition in a Business Combination

- **Exercise**

Listed below are items which are controlled by the target company in a business combination:

A. Assembled workforce

B. Customer list

C. Favourable operating lease contract

D. Non competition agreements

Identify the intangible assets.

Acquisition in a Business Combination

- **Answer**

Listed below are items which are controlled by the target company in a business combination:

A. Assembled workforce = *not an identifiable asset*

B. Customer list - *separable*

C. Favourable operating lease contract – *Contractual rights*

D. Non competition agreements – *Contractual rights*

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Specialised Valuation Techniques

- **Entities may have developed techniques for estimating FV of intangible assets indirectly**
- **Techniques may be used for initial measurement if they reflect current transactions and practices in the industry**

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Specialised Valuation Techniques

- **Examples of valuation techniques**
  - Applying multiples reflecting current transactions to indicators that drive the profitability (such as revenue, market shares and operating profit) or to royalties that could be obtained from licensing the asset
  - Discounting estimated future net cash flows from the asset

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Acquisition in a Business Combination

- **Goodwill arising in business combination (SLFRS 3)**
  - Recognise in consolidated statement of financial position
  - Must not amortise
  - Must test for impairment at least annually

- **Internally generated goodwill (LKAS 38)**
  - Difference between market value of entity and the carrying amount of its identifiable net assets is not cost of intangible assets controlled by the entity
  - Must not be recognised as an asset

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Internally Generated Intangibles

- **Other forms of internally generated intangible must be assessed to ensure they qualify for recognition**
  - Identifying the point of time when probable future economic benefits occur; and
  - Reliable determination of cost of the asset.
- **LKAS 38 requires the generation of the asset to be classified into two phases**
  - Research; and
  - Development

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Internally Generated Intangibles

- **Research phase**
  - No intangible asset is recognised
  - Expense costs as incurred
  - Examples
    - Activities aimed at obtaining new knowledge
    - Search for, evaluation, and final selection of applications of research findings
    - Search for alternatives for materials, devices, products, processes, systems or services
    - the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services

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Internally Generated Intangibles

- **Development phase**
  - Examples
    - Design, construction and testing of preproduction models
    - Design of tools, jigs, moulds, and dies involving new technology
    - Design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production
    - Design, construction and testing of a chosen alternative for new or improved materials, devices, processes, products, systems or services
  - Costs must be capitalised where criteria met

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Internally Generated Intangibles

- **Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance must not be recognised**
  - LKAS 38 states that expenditure on such assets cannot be distinguished from the cost of developing the business as a whole

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Internally Generated Intangibles

- **Development phase**
  - Capitalisation required if all the following are met:
    1. Technical feasibility of completing the IA
    2. Intention to complete the IA and use or sell it
    3. Ability to use or sell the IA
    4. How economic benefits will be generated – existence of a market or if used internally its usefulness
    5. Availability of adequate technical or financial resources to complete the IA and to use or sell it, and
    6. Ability to measure reliably the expenditure attributable to the IA during its development

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Internally Generated Intangibles

- **Cost of an internally generated intangible**
  - Sum of expenditure incurred from the date when the recognition criteria is first met
  - Cannot reinstate expenditure previously expensed
  - Comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management

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Internally Generated Intangibles

- **Examples and issues relating to identification of future economic benefits and measuring cost**
  - May increase future cash flows on its own or in combination with other assets
  - Financing witnessed by business plan/lenders willingness to finance it
  - Time recording system to capture costs of staff
  - Evaluation at each reporting date

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Costing Systems

- **Entity's costing systems must measure reliably the cost of generating an intangible asset internally**
- **Example – costs may include salary and other costs incurred in:**
  - Securing copyrights
  - Securing licenses
  - Developing computer software

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Internally Generated Intangibles

Exercise

Entity P recently developed a series of new cooking pots which can reduce cooking time by 40%-60% on average. The following are the costs incurred by the entity:

1. Study on the use of pots by household owners LKR9,000
2. Trial runs on various materials to identify a suitable material to make pots LKR120,000
3. Cost of staff and experts developing the new pots LKR 52,000
4. Material used in the designing of new pots LKR12,000
5. Pre production testing LKR15,000
6. Training conducted for sales staff on the new pots LKR6,000
7. Legal fees to patent the making of the pots LKR10,000

What items should be capitalised by entity P as an intangible asset?

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Internally Generated Intangibles

Answer

Entity P recently developed a series of new cooking pots which can reduce cooking time by 40%-60% on average. The following are the costs incurred by the entity:

1. Study on the use of pots by household owners LKR9,000 – **Not an IA**
2. Trial runs on various materials to identify a suitable material to make pots LKR120,000 **– Not an IA**
3. Cost of staff and experts developing the new pots LKR 52,000 **- IA**
4. Material used in the designing of new pots LKR12,000 - **IA**
5. Pre production testing LKR15,000 **- IA**
6. Training conducted for sales staff on the new pots LKR6,000 **– Not an IA**
7. Legal fees to patent the making of the pots LKR10,000 **- IA**

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Measurement after Recognition

- **Policy choice – cost or revaluation**
- **Cost model**
  - Carry at cost less accumulated amortisation and impairment losses
- **Revaluation model cannot be chosen unless there is an 'active market' for the asset in question**
  - Needed to determine the asset's fair value
  - Revaluations should be performed regularly
  - Other assets in its class shall also be revalued

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Measurement after Recognition

- **Revaluation model**
  - Carry at fair value at date of revaluation less any subsequent accumulated amortisation and impairment losses
  - Fair value
    - Determined by reference to an **active market** in that type of intangible
    - Use of valuation techniques is considered not sufficiently reliable
  - Changes in the carrying amount
    - Increases recognised under other comprehensive income unless to the extent decreases have been recognised in profit and loss for the same asset
    - Decreases recognised in profit and loss unless to the extend increases have been recognised under revaluation surplus for the same asset

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Measurement after Recognition

- **Useful life**
  - Finite
  - Indefinite means 'no foreseeable limit to period over which the asset is expected to generate net cash flows for the entity'
    - Not same meaning as 'infinite'

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Finite Useful Lives

- **Amortisation**
  - Allocated on a systematic basis over its useful life
  - Begins when asset is available for use
  - Method used reflects the pattern in which future economic benefits are expected to be consumed
    - If pattern cannot be determined reliably, straight-line method is used
  - Recognised in profit or loss
  - Residual value assumed to be zero unless:
    - There is a commitment by a 3rd party to purchase it at end of useful life, or
    - There is an active market for the asset

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Indefinite Useful Lives

- **Do not amortise**
- **Test for impairment (LKAS 36)**
  - Annually, and
  - Whenever there is an indication that the intangible asset may be impaired
- **Useful life**
  - Review each period to determine if circumstances continue to support indefinite useful life assessment
    - If not, begin to amortise (account for as a change in estimate)

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Amortisation

- **Exercise**

Entity X acquires 3 intangible assets on 1 January 2014:

- Asset 1 costs LKR300, has no estimated residual value and has an estimated useful life of 3 years. Since the pattern in which the assets future economic benefits are to be consumed cannot be reliably determined management plans to charge 50% amortisation in year 1, 30% in Year 2 and 20% in year 3.
- Asset 2 costs LKR400. Although it has an indefinite expected life, management believes that assigning it a 5 year life is prudent.
- Asset 3, although is immediately ready for use, management decided not to use it until next year. The asset will cease to have any use by 31 December 2018. It costs LKR200 and will have no value at the end of its useful life . The pattern in which economic benefits are to be consumed cannot be determined reliably.

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Amortisation

Exercise

Entity X acquires 3 intangible assets on 1 January 2014:

- Asset 1 costs LKR300, has no estimated residual value and has an estimated useful life of 3 years. Since the pattern in which the assets future economic benefits are to be consumed cannot be reliably determined management plans to charge 50% amortisation in year 1, 30% in Year 2 and 20% in year 3. – **amortised on a straight line basis over 3 years**
- Asset 2 costs LKR400. Although it has an indefinite expected life, management believes that assigning it a 5 year life is prudent. **– no amortisation as it has an indefinite useful life**
- Asset 3, although is immediately ready for use, management decided not to use it until next year. The asset will cease to have any use by 31 December 2018. It costs LKR200 and will have no value at the end of its useful life . The pattern in which economic benefits are to be consumed cannot be determined reliably. – **amortised on a straight line basis over 4 years**

Disclosure

For each class of intangible asset

- Indefinite or finite useful life, useful life, amortisation rate
- Amortisation method used
- Gross carrying amount and any accumulated amortisation at beginning and end of period
- Line items of statement of comprehensive income containing amortisation
- Reconciliation of carrying amount, beginning and end of period
- Identify intangible assets with indefinite useful life and reasons supporting classification
- Individually material intangible assets – description and carry amount
- Pledged as security or title restricted
- Revalued date, and movement in the revaluation surplus
- Aggregate amount of R&D expenditure recognised as an expense

Additional Encouraged Disclosures

- **Description of any fully amortised intangible assets still in use**
- **Description of significant intangible assets controlled by the entity but not recognised as assets**
  - Did not meet the recognition criteria
  - Acquired or generated before IAS 38 (1998 version) was effective