



HM TREASURY

Financial Reporting Advisory Board Paper

IAS 38: *Intangible Assets*

Issue:	The application of IAS 38: <i>Intangible Assets</i> in the context of resource and other accounts covered by the Government Financial Reporting Manual.
Impact on guidance:	The proposed text in Annex A relates to the shadow FReM.
IAS/IFRS adaptation?	No
IPSAS compliant?	N/A
Interpretation for the public sector context?	Yes – the option of using the cost model for subsequent measurement is withdrawn.
Impact on budgetary regime?	Yes – likely to result in capitalisation of intangible assets previously not capitalised.
Alignment with National Accounts	Yes, in part.
Impact on Estimates?	Yes – likely to result in additional resource requirements.
Recommendation:	That the Board agree that IAS 38 applies in full, as interpreted.
Timing:	Not yet known: depends on future decision on date for moving to EU-adopted IFRS.

DETAIL

Background

1. IAS 38 *Intangible Assets* was issued in March 2004 and is applied to the accounting for intangible assets acquired in business combinations after 31 March 2004, and to all other intangible assets for annual periods beginning on or after 31 March 2004.

Objective of IAS 38

2. The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specific criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

Scope of IAS 38

3. IAS 38 applies to all intangible assets **except** for:
- a. Intangible assets that are within the scope of another Standard, e.g. intangibles held for sale (IAS 2 *Inventories* and IAS 11 *Construction Contracts*), deferred tax assets (IAS 12 *Income Taxes*), lease assets (IAS 17 *Leases*), assets arising from employee benefits (IAS 19 *Employee benefits*) and goodwill (IFRS 3 *Business Combinations*);
 - b. Financial assets;
 - c. Mineral rights and expenditure on exploration for, or development and extraction of non-regenerative resources;
 - d. Intangible assets arising from insurance contracts issued by insurance companies.

Definition, initial recognition and measurement

4. An intangible asset is an identifiable non-monetary asset without physical substance.
5. An intangible asset, whether acquired externally or generated internally, is initially recognised at **cost** if all of the following criteria are met:
- a. The asset meets the definition of an intangible asset, i.e. it is identifiable and controlled by the entity;
 - b. It is probable that future economic benefits that are attributable to the asset will flow to the entity (which may include cost savings or other benefits resulting from the use of the asset by the entity rather than revenue from sales); and
 - c. The cost of the asset can be reliably measured.
6. IAS 38 includes additional recognition criteria for internally generated intangible assets where it is sometimes difficult to assess whether the assets meet the above recognition criteria. To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:
- a. a research phase; and
 - b. a development phase.

No intangible asset arising from research (or from the research phase of an internal project) is capitalised, but is expensed as it is incurred.

7. IAS 38.57 requires that an intangible asset arising from development is capitalised if, and only if, the entity can demonstrate all of the following:

- 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;
- f. its ability to measure reliably the expenditure attributable to the intangible asset during its development.

8. If an intangible asset does not meet the criteria for recognition as an asset, the expenditure is recognised as an expense when incurred. Expenditure that was initially recognised as an expense is not included in the cost of an intangible asset at a later date.

9. IAS 38.63 specifically prohibits the recognition as intangible assets of brands, mastheads, publishing titles, customer lists and items similar in substance that are internally generated, in that they are not separable, i.e. that they cannot be distinguished from the cost of developing the business as a whole.

Subsequent measurement

10. IAS 38 permits the use of either the cost model or the revaluation model for each class of intangible asset:

- a. Cost model. After initial recognition the benchmark treatment is that intangible assets should be carried at cost less any amortisation and losses;
- b. Revaluation model. After initial recognition intangible assets may be carried at a revalued amount (based on fair value, i.e. open market value) less any subsequent accumulated amortisation and any accumulated impairment losses, but only if there is an active market for the asset. Under the revaluation model, revaluation increases are credited directly to equity as revaluation surplus, i.e. to a revaluation reserve in the public sector context, except to the extent that it reverses a revaluation decrease previously recognised.

11. For the public sector context, in which modified historical cost accounting applies, it is proposed that the IAS 38 option of subsequent measurement at cost be withdrawn. Following initial recognition, intangible assets should be carried at valuation at the balance sheet date.

Classification of intangible assets based on useful life

12. An entity assesses whether the useful life of an intangible asset is finite or indefinite. The useful life is indefinite if there is no foreseeable limit to the period over which the asset is expected to generate net cash flows. An intangible asset with an indefinite useful life is not amortised, but it is tested for impairment at least annually. For an intangible asset with a finite life, the depreciable amount is amortised on a systematic basis over its useful life.

Disclosure

13. For each class of intangible assets entities are required to disclose:

- a. The useful life or amortisation rate;
- b. Amortisation methods for finite assets;
- c. Gross carrying amount and any accumulated amortisation and impairment losses;
- d. Line items in the income statement in which amortisation is included;
- e. A reconciliation of the carrying amount at the beginning and end of the period showing:
 - 1) Additions (business combinations separately);
 - 2) Assets classed as held for sale;
 - 3) Revaluations;
 - 4) Impairments;
 - 5) Reversals of impairments;
 - 6) Amortisation;
 - 7) Foreign exchange differences.

Comparison with requirements under UK GAAP

14. FRS 10 *Goodwill and Intangible Assets* requires that an intangible asset purchased separately from a business should be capitalised at cost. It further requires that an intangible asset acquired as part of the acquisition of a business should be capitalised separately from goodwill if its value can be measured reliably on initial recognition. IAS 38 applies specific recognition criteria on the initial recognition of intangible assets (para 5).

15. FRS 10 has a rebuttable presumption that the useful economic lives of intangible assets are limited to periods of 20 years or less, unless otherwise justified and the asset is capable of continued measurement. IAS 38 requires that amortisation of an asset with a finite life be amortised on a systematic basis over its useful life, and provides examples of useful life for different types of intangible assets.

16. FRS 10 requires that internally developed intangible assets should be capitalised only where they have a readily ascertainable market value. IAS 38 applies additional specific recognition criteria for internally developed intangible assets (para 7), and does not recognise internally generated brands or other items similar in substance as intangible assets.

17. SSAP 13 *Research and Development* requires that expenditure on pure and applied research (other than the cost of fixed assets acquired or constructed in order to provide facilities for research and development activities over a number of accounting periods) should be expensed as incurred.

18. SSAP 13 permits but does not require, the capitalisation of development costs when the recognition criteria are met. IAS 38 requires capitalisation when the recognition criteria are met.

19. SSAP 13, as currently adapted in the FReM, requires that development expenditure be capitalised where there is a clearly defined project for which expenditure can be separately identified and which an entity expects to complete with the result that an asset will be brought into use or in the case of entities engaged in profit making activities, where the project is commercially viable. A further SSAP 13 adaptation in the FReM is that internal costs, including the cost of capital charge, should not be capitalised if they relate to activities that can only be carried out by the in-house staff.

Impact of IAS 38 on public sector accounts

20. Entities covered by the requirements of the FReM may from time to time have intangible assets. The IAS 38 recognition criteria for intangible assets is more prescriptive than under existing UK GAAP adapted standards. Nevertheless, it is proposed that in principle, IAS 38 should apply in full, as interpreted, to entities covered by the shadow FReM. This means that some entities previously not capitalising internally generated intangible assets, may be required to do so if the relevant recognition criteria are met. For such entities, the full application of IAS 38, as interpreted, raises two issues of practicality on adoption and subsequent application of the Standard. These relate to:

- a. Initial recognition on a cost basis. Where intangible assets have been generated over a lengthy time period, it is likely that some entities will not have a reliable historical record of costs to enable initial recognition at cost in the balance sheet. In such cases, capitalisation is likely to be prospective from adoption of the Standard, and not retrospective.
- b. Subsequent revaluation. It is likely in practice that some entities may not be able to apply the revaluation model, based on fair value, due to the absence of an active market for the asset. When market values are not available it is proposed that amortised replacement cost is used.

21. The full application of the Standard, as interpreted, also means that where the IAS 38 recognition criteria are met, the current FReM exemption from capitalising internal costs where they relate to activities that can only be carried out by in-house staff, will no longer apply, i.e. all such costs will be required to be capitalised.

Impact on disclosures in resource and other accounts

22. The presentation and disclosure requirements of IAS 38 will be taken into account in developing the format of resource and other accounts in the light of the move to EU-adopted IFRS and other initiatives.

IAS/IFRS compliance

23. The proposals are compliant with IAS 38.

IPSAS compliance

24. IPSASB has not issued an IPSAS on intangible assets.

Proposed text for the shadow Government Financial Reporting Manual

25. See Annex A for the proposed amendments to the shadow FReM.

Impact on the budgetary regime

26. The proposals in practice are likely to result in a material change to the accounting for intangible assets for some entities, and so the implementation of IAS 38 is likely to have a corresponding impact on the budgetary regime for those entities.

Alignment with National Accounts

27. The proposal aligns with National Accounts in part. Research and development expenditure is currently treated as consumption, although proposals being put forward as part of the re-write of SNA93 will change this. Computer software is treated as capital.

Summary and recommendation

28. IAS 38 deals with the recognition and subsequent accounting for intangible assets that are not dealt with in another Standard. In practice, the implementation of IAS 38 is likely to result in the capitalisation of some intangible assets previously not capitalised, and correspondingly, have a material effect on the accounting and budgetary regime for some public sector entities in comparison with the current FReM requirements.

29. The full application of the Standard, as interpreted, is also likely to raise practical difficulties for some entities in relation to initial cost recognition of the assets and subsequent measurement at revaluation, which will need to be addressed. However, in principle, it is recommended that the Standard be implemented in full, as interpreted.

30. The Board is invited to approve the proposed text for the shadow FReM at Annex A.

HM Treasury
29 June 2006

PROPOSED TEXT FOR THE SHADOW GOVERNMENT FINANCIAL REPORTING MANUAL

IAS 38: *Intangible Assets*

Applicability

IAS 38 applies in full, as interpreted.

Objective of IAS 38

The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specific criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

Interpretation of IAS 38 for the public sector context

Following the initial recognition of an intangible asset, for subsequent measurement IAS 38 permits the use of either the cost or revaluation model for each class of intangible asset. All intangible assets should be carried at valuation at the balance sheet date, i.e. by reference to an active market – that is the cost option given in IAS 38 has been withdrawn.