
Accounting for intangible assets

- Lloyd Austin



STANLEY PALMER, *Towards Pararaha*, 1971, bamboo engraving and lithograph.
The University of Auckland Collection

Accounting for intangible assets

The development of an accounting standard for intangible assets has taken a long time, and it has been controversial. To understand the problems involved, it is necessary to look at the nature of assets and the special case of intangibles.

By Lloyd Austin

Assets are expenditures made with the intention of earning future benefits through enhanced profits and cash flows. Such expenditures are “capitalised” as assets in the balance sheet. It is relatively easy to identify tangible assets such as land and buildings, plant and equipment, vehicles and inventories. Financial items like cash, accounts receivable and investments, which are claims to future benefits are also included as assets even though they are not tangible. In addition to these resources, the firm may have expended funds to acquire a third category of assets known as intangibles. A typical definition¹ of these is: “an intangible asset is a claim to future benefits that does not have a physical or financial embodiment.” Common examples include patents, copyright agreements, brands, research and development expenditure, and franchises. A more complete

list is given in the sidebar.

Externally acquired intangibles are purchased from outside the firm and usually have identifiable costs and discernible benefits. However, there have been difficulties in accounting for these assets. There has been a conservative tendency to expense many of the costs involved, and for those capitalised there have been inconsistent approaches to recording, revaluing, and amortising these assets. Table 1 shows the reported intangible assets from New Zealand listed companies reporting in the 2005 year. In nearly all cases the intangibles were purchased by the companies concerned.

Table 1 shows a diverse range of assets, the costs capitalised ranging from payments for goodwill to trademarks, licences, franchises, and payments for wind rights and grape supply contracts. However, the level of disclosure is small. The disclosed intangible assets constitute about 10.9 percent of the sample companies’ total assets. This conceals the fact that, in some cases, the intangible assets provide a much larger percentage of the company’s assets. For example, Canwest has 85 percent of its recorded assets as goodwill, Mike Pero over 78 percent, and Gullivers Travels over 76 percent. In addition, non-listed entities have significant intangibles. For example, in the 2005

Lloyd Austin has been a Senior Lecturer in the Department of Accounting and Finance since 1989. Before then he was involved in accounting for large corporates and teaching both in New Zealand and overseas.

year Fonterra, the dairy conglomerate reported intangibles of \$1.47 billion, including goodwill of \$220 million and purchased brands of \$1.2 billion.

INTERNALLY GENERATED INTANGIBLES

Intangible assets that are developed within the firm, the “internally-generated” intangibles, have caused recognition problems. These assets are developed, usually over a period of time, within the firm and have traditionally been ignored, that is, not recognised in the financial statements.

Generally, the reason for the omission from the financial statements of these internally generated intangible assets has been due to a perceived lack of a relation between their costs and specific future revenue, an issue which is considered later in this article. In addition, the difficulties in ascertaining cost or valuation figures for intangibles and a focus on reliability over relevance² when disclosing asset information have meant that self-generated intangibles have not usually been recognised. Most of these reasons constitute a “hang-over” from what some commentators have called the “old” economy in which the value creating assets were largely physical and the outputs were in a clearly tangible form. Although the presence of intangibles has long been known,³ they were not perceived as important in the creation of value before the 1950’s. This might have been a reasonable view even up to the 1980’s, from which time there is evidence that the significance of intangible assets has increased rapidly.⁴ That is, the value drivers of the firm became increasingly intangible with less of the market capitalisation explained by the mainly tangible assets recognised in financial statements.

IMPORTANCE OF INTERNALLY GENERATED INTANGIBLES

The importance of internally generated intangibles has been reflected in the increasing proportion of the company’s market value attributable to the existence of intangibles. For example, in some firms, brand assets are important and table 2 shows the estimated contribution of brands to shareholder market value for a sample of

Executive Brief

This article describes the nature of intangible assets. It gives an overview of the importance of intangibles and their characteristics which have made it difficult to formulate a standard. It describes the requirements of the IASB’s *International Accounting Standard 38 Accounting for Intangible Assets* and considers the consequences of its adoption.

Table 1

Disclosure of intangible assets for New Zealand listed companies reporting in the year ending 31 December 2005

INTANGIBLE ASSET	COST (\$'000)	NUMBER OF COMPANIES
Brands	973,467	31
Capitalised development costs	17,862	12
Goodwill	4,350,971	60
Intellectual Property	123,303	9
Leasehold interests	4,838	2
Licences	389,308	5
Mastheads	1,144,183	1
Management contracts	1,226	1
Process	96,798	2
Resource rights	100,304	7
Restrictive covenants	363	1
Software	50,661	15
Intangibles specified as “Other”	8,847	7
Total Intangible assets	7,165,333	
Total assets of sample companies	65,749,936	
Number of sample companies	145	

Source: IRG Datex 2005 Database

international companies.

Table 2 compares the estimated market value of the company’s brands to the market value of the company. Significantly, most of these firms do not record the value of the brands in their balance sheets because they are (largely) internally generated. The importance of brands to the market values of New Zealand and Australian companies shows a similar pattern. For example, in Lion Nathan’s 30 September 2005 financial statements,⁵ brands made up \$2,381 million of the total assets of \$4,064 million. The brands constituted 39.3% of the market value of the company’s debt and equity (its enterprise value) and 58.6% of the market value of equity. In New Zealand, other companies do not recognise internally generated brands in their balance sheets, the exception being Telecom which published supplementary information on its brand values in its 1998 financial statements. In that year, brands constituted 36% of the total assets and 14.6% of Telecom’s enterprise value.

The importance of intangible assets has also been the subject of scrutiny by investment analysts and academics. For example, two leading commentators⁶ on intangibles argue that the increasing rate of business change, largely driven by investments in intangibles coupled with the delayed

recognition of this change in the accounting system is reflected in the declining usefulness of accounting information. Specifically, they found that the cross-sectional association between reported earnings and share returns declined over the 20 years to 1996. The measure of association used, the R^2 , fell over the period, averaging 6-12% in the first 10 years and 4-8% in the second 10 years. This decline is a function of the mismatch of expenditure on intangible assets, which is expensed immediately while the benefits occur later. The same idea⁷ has been called a combination of the “time gap” and the “correlation gap”. The time gap describes the costs of intangibles that occur long before the resulting product can demonstrate probable benefits. The correlation gap asserts that the relation between the value of intangibles and future benefits does not exist, or is not as clear as that for tangible assets. Both gaps have tended to hinder the recognition of intangible assets.

Another study⁸ looked at the ratio between the market price and book value of the shares (the price-to-book ratio) of the US Standard and Poor 500 companies for the period 1997-2001. The ratio increased from just over 1:1 in the beginning of the period to about 6:1 in 2001. The conclusion drawn⁹ was that: “for every six dollars of market value, only one dollar appears on the balance sheet, while the remaining five dollars represent intangible assets.” As noted, the importance of intangibles was well understood before the 1980’s, but the intensified business competition arising from globalisation and deregulation and the advent of information technologies from this period have made intangibles more value relevant.

The importance of intangible assets has been the subject of scrutiny by investment analysts and academics.

The nature of internally generated intangibles can be further explained by comparing the accounting recognition of intangibles and the market value of the firm by way of an example. Assume that a firm’s recognised total funds (the *book* values of debt and equity) and total assets, including recognised externally acquired intangible assets, are each \$100 in its balance sheet. This is the accounting position. However, the firm’s enterprise value (the *market* values of debt and equity) is \$600. The relation between the recorded accounting position and the separately determined market value of the firm is shown in figure 1.

Assuming the recognised assets include externally acquired and other qualifying intangibles, current reporting practice does not recognise any other intangible assets in the financial statements, even though the \$500 difference may be recognised by the market.

ACCOUNTING STANDARDS

Given the issues discussed above, the attempts to prescribe accounting treatments for intangible assets were initially piecemeal and conservative. Many intangible assets (for example, expenditure to develop brand assets) were not adequately covered by early accounting standards. To guide and justify their accounting treatment of these other intangibles, companies fell back on broad principles of asset determination and recognition, especially those contained in the various country’s conceptual statements which were

Table 2

The contribution of brands to shareholder value

COMPANY	2002 BRAND VALUE (\$USb)	BRAND CONTRIBUTION TO MARKET CAPITALISATION OF PARENT COMPANY (%)	2001 BRAND VALUE (\$USb)
Coca-cola	69.6	51	69.0
Microsoft	64.1	21	65.1
IBM	51.2	39	52.8
GE	41.3	14	42.4
Intel	30.9	22	34.7
Nokia	30.0	51	35.0
Disney	29.3	68	32.6
McDonald’s	26.4	71	25.3
Marlboro	24.2	20	22.1

Source: Business week, Interbrand/JP Morgan league table, 2002.

developed partially for such purposes.¹⁰ These conceptual statements usually gave the option of capitalising or expensing some intangibles, depending on the firm’s interpretation of the definition of assets. Most companies chose not to capitalise intangibles other than those meeting the criteria in the research and development standard. There were exceptions, for example, in New Zealand Lion Nathan included brand assets in its balance sheet¹¹ from the 1980’s. Other New Zealand firms valued brands but did not incorporate the values obtained in their balance sheets, though publishing firms like APN capitalised the value of their mastheads.

IAS 38 INTANGIBLE ASSETS

The issue of *IAS 38 Accounting for Intangible Assets* in 1998, though not binding on most countries until at least 2005,¹² provided guidance on intangibles. The standard defines an intangible asset as: “an identifiable non-monetary asset without physical substance”. Identifiable means that the asset is either separable, that is, it can be sold apart from the firm’s other assets or it arises from contractual or other legal rights. These essential criteria of intangibles are *additional* to those applicable to other types of assets, namely that there must be probable future economic benefits which are

Our intention is to be clear, concise and above all consistent.

* THREE YEARS IN A ROW

IFLR: Named New Zealand Law Firm of the Year.

* FOUR YEARS IN A ROW

Chambers Global: Most leading individuals in New Zealand and top-tier rankings in banking and finance, corporate/commercial, litigation, employment and tax. Only top-tier corporate practice in 2006 and 2007, and only top-tier litigation practice in 2007.

* FIVE YEARS IN A ROW

Asia Pacific Legal 500: Most leading individuals and most leading practice areas in New Zealand.

* FOUR YEARS IN A ROW

Thomson Financial: New Zealand's leading M&A adviser.

* FOUR YEARS IN A ROW

PLC Which Lawyer: Most leading practice area rankings in New Zealand.

* THREE YEARS IN A ROW

International Tax Review: New Zealand's leading legal tax practice.

attributable to the asset which will flow through to the firm and the cost of the asset can be measured reliably.

IAS 38 provides that intangibles can be obtained by the firm in a number of ways:

- by separate purchase
- by self-creation, that is internally generated by the firm
- by an exchange of assets
- as part of a business combination

In addition, intangibles can arise from a government grant. These latter assets are covered by their own standard, *IAS 20 Accounting for Government Grants*, and are normally recognised in the balance sheet at their fair value. Intangibles arising from an exchange of assets are treated similarly to asset purchases and are usually recognised at the fair value of the intangible

Figure 1

Current reporting practice versus the market value of the firm

	CURRENT PRACTICE	MARKET VALUE
Recorded assets including recognised intangibles	100	100
Internally generated intangible assets not recognised as assets in current practice	---	500
Total assets	100	600
Liabilities and equity	100	600

asset acquired or the asset exchanged whichever is the more clearly determined.

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

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

- the research phase
- the development phase

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

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

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

However, any expenditure made on the asset *before* the criteria are satisfied cannot be recognised as part of the asset’s cost and must remain expensed in the period they were incurred. Thus the expenditures which are recognised for an internally generated intangible asset may not comprise its entire cost. In addition to this problem, *IAS 38* specifically prohibits capitalisation of the costs of some internally generated intangible assets, even if they meet the development criteria mentioned above. Such costs must be expensed when incurred and include expenditure on:

- internally generated brands and internally generated goodwill
- mastheads
- publishing titles
- customer lists
- and other items “similar in substance” to the above

Expenditures on these assets do not pass the separable asset test, meaning that their costs cannot be distinguished from the costs of developing the business as a whole. There are also other intangibles specifically listed in *IAS 38* which do not meet the identifiability criteria, for example, the costs of ongoing training or recruitment programs, advertising, relocation, start-up, pre-opening and pre-operating costs. Additionally, though not separately named, the costs of developing favourable government relations and establishing a presence in geographic markets or locations would not be recognised on the same grounds, that is, the values and costs of separating these assets from others would be too difficult.

ACQUISITION AS PART OF A BUSINESS COMBINATION

The restrictions on the recording of internally generated intangible assets apply at the individual company level, but when the assets of a firm are part of a “business combination” the rules change. The most common form

of business combination is a takeover, when an individual company becomes part of a larger grouping of companies. In this case, the parent company acquires all or a majority of the shares of another company, the subsidiary. After the acquisition, the two companies carry on as individual entities, producing their own financial statements. As the parent and subsidiary now form a group of companies, a third set of financial statements is required, which adds the income and

If the fair value of the separable intangible assets can be reliably measured, they can be recognised in the consolidated balance sheet.

expenses, assets and liabilities of all the individual companies in the group to produce a consolidated income statement and a consolidated balance sheet.

The significance of this process is that *LAS 38* allows intangibles, which may not have passed the recognition test at the individual subsidiary company level (and are therefore excluded in the subsidiary's accounts), to be recognised when the assets of the subsidiary are added to those of the parent to form the consolidated balance sheet. The intangibles of the subsidiary are now recognised because the parent obtained control of the assets, including intangibles, when the ownership interest in the subsidiary company was acquired. The previously unrecognised intangibles are treated similarly to purchased or externally acquired intangibles. A schedule of the intangibles which could be separately recorded in such situations is listed in the sidebar. Significantly, if an individual company with research and development expenditure is acquired in a business combination, the consolidated balance sheet may recognise all the project costs (including the research costs) as an asset. Subsequent expenditure on the project must meet the capitalisation criteria discussed earlier.

The position can be illustrated by extending the data used in the previous example, shown in figure 1. In that example, intangible assets of \$500 were not recognised by the individual company. Assuming that this company is now

part of a business combination and \$300 of the previously unrecognised (and ignored) intangibles are now recognised in the group balance sheet, the resulting position can be shown in figure 2.

If the fair value of the separable intangible assets can be reliably measured, they can be recognised in the consolidated balance sheet. Otherwise they are recognised in goodwill. The recognition of the separable intangible assets at their fair value would appear to contradict the *LAS 38* requirement to initially record intangible assets at cost. However, the presumption is that, as the company was acquired by the parent at the market price, the intangibles were purchased at fair value as well. The balance of the intangible assets still not recognised (\$200) are those which do not meet the separability and fair value tests. They are included in the group balance sheet as goodwill arising on consolidation. The higher the value put on the separate intangibles the lower will be the recognised goodwill.

REVALUING INTANGIBLE ASSETS

Generally, tangible assets which are the subject of *LAS 16 Property, Plant and Equipment* are divided into classes. Each class, which contains assets of similar use or characteristics, may be carried at their cost price (the "cost" model) or at a fair value figure (the "revaluation" model). The fair value is approximated by the market value. Apart from land, tangible assets have a finite life and are systematically depreciated over their useful lives, together with a requirement to test for their impairment where there is evidence of this.¹³

Intangible assets are also divided into appropriate classes which the firm can carry at cost or at a revalued figure in the balance sheet. Both externally acquired and permitted internally generated intangibles are initially recognised at cost (apart from those recognised as part of a business combination, which are recognised at fair value) and this is the benchmark position for most intangibles. To qualify for revaluation, *LAS 38* imposes an extra requirement on intangibles which does not apply to tangible assets, that is, the fair value must be

Figure 2

Recognition of intangibles in individual companies versus recognition when part of a business combination

	INDIVIDUAL COMPANY'S BALANCE SHEET (\$)	COMPANY'S ASSETS AS INCLUDED IN CONSOLIDATED BALANCE SHEET (\$)
Recorded assets including recognised intangibles	100	100
Internally generated intangibles now identified and recognised at fair value when the company is included in a group	---	300
Balance of internally generated intangibles still not recognised – now subsumed under 'goodwill' heading and recognised as such in the consolidated balance sheet	---	200
Total assets	100	600
Liabilities and equity	100	600

obtained with reference to an active market for the asset.

An active market is defined as one in which all the assets traded are homogenous, there are many buyers and sellers, and where the prices are available to the public. Active markets for intangibles and thus revaluations are expected to be uncommon. In this respect, *IAS 38* considers some intangibles to be “unique” and therefore disallows the subsequent revaluation of purchased brands, mastheads, patents and trademarks. However, other intangibles like freely transferable taxi and fishing licences and production quotas, may meet the criteria for revaluation. Other intangibles that may qualify for revaluation include cable TV operating licenses and EU milk quotas. Intangibles are revalued in the same way as tangible assets. An upward revaluation increases the recognised balance sheet asset value with the increment credited to a revaluation surplus which is part of equity.

AMORTISATION AND IMPAIRMENT

IAS 38 requires an entity to assess the useful life of its intangibles into those with finite and those with indefinite lives. Amortisation applies to those with finite lives and requires an estimate of the useful life of the asset. There is a rebuttable presumption that the maximum amortisation period is 20 years. Those with indefinite lives are not systematically amortised but must be assessed at least annually for possible impairment adjustments. According to *IAS 38*, intangible assets have an indefinite life when “there is no foreseeable limit to the period over which the asset is expected to generate net cash flows for the entity”. Another accounting standard *IAS 3 Business Combinations* prohibits the amortisation of goodwill. In practice recognised brand assets are also often assumed to have indefinite lives.

Because the cash flows generated by goodwill attach to the other assets rather than goodwill, its impairment is more complex. The test for goodwill impairment compares the current *market* value of the subsidiary’s equity with the balance sheet value of its equity plus the goodwill arising on the original acquisition. If the current market value is below the balance sheet value of the equity (plus goodwill) then the value of the investment in the subsidiary has fallen and the goodwill is impaired.

As the recorded goodwill is a function of the price paid for the acquisition, impairment means the acquisition price was too high relative to the current value of the investment. There are a number of cases where this issue has arisen. For example, in 2001, the UK firm Vodafone paid £101,436 billion for the equity (net assets) of the German telecommunications company Mannesman. At the date of acquisition, Mannesman’s balance sheet equity had a fair value of £18,408 billion. The surplus of £83,028 billion was recorded as goodwill in the consolidated financial statements. In subsequent years, the goodwill was systematically amortised, till 2005 when the newly adopted *IAS 38* required Vodafone to cease amortising the goodwill but test it for impairment. The value of the investment had fallen dramatically and in 2005, Vodafone recognised an impairment of £19.4 billion in the goodwill

What is an intangible asset?

These are examples of an entity’s intangible assets that meet the criteria for recognition separate from goodwill when the assets are part of a business combination. The list is adapted from the FASB Statement of Financial Accounting Standards No. 141 Business Combinations, which has similar criteria to IAS 38.

Marketing-related intangible assets

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

Customer-related intangible assets

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

Artistic-related intangible assets

- Plays, operas, ballets
- Books, magazines, newspapers, other literary works
- Musical works such as compositions, song lyrics, and advertising jingles
- Pictures, photographs
- Video and audiovisual material, including motion pictures, music videos, television programs

Contract-based intangible assets

- Licensing, royalty, standstill agreements
- Advertising, construction, management, service or supply contracts
- Lease agreements
- Construction permits
- Franchise agreements
- Operating and broadcast rights
- Use rights such as drilling, water, air, mineral, timber cutting, and route authorities
- Servicing contracts such as mortgage servicing contracts
- Employment contracts

Technology-based intangible assets

- Patented technology
- Computer software and mask works
- Unpatented technology
- Databases, including title plants
- Trade secrets, such as secret formulas, processes, recipes.

in Mannesman. In addition, the goodwill in its Italian and Swedish subsidiaries was impaired by £3.6 billion and £515 million, respectively, in the same year, resulting in a total impairment expense of £23.5 billion. This was a direct reduction of the recorded goodwill assets and a charge against income of that year.

Closer to home, other examples include The Warehouse's and Telecom's investments in Australia. In 2000, The Warehouse

Another longer term effect may be a further increase and reliance on the use of non-financial indicators.

paid \$114 million for the equity in its Australian subsidiary. The fair value of the net assets of the subsidiary was \$36.2 million which meant that the payment for goodwill was \$77.8 million. This sum was systematically amortised until 2005, when the remaining goodwill was tested for impairment. The Australian operations had fared badly and

as a consequence, the remaining balance of the unamortised goodwill (\$22.1 million) was impaired. This impairment expense was taken as a direct reduction of income in 2005. In 2006, the subsidiary was sold.

Similarly, in 2001, Telecom completed a piecemeal acquisition of its Australian subsidiary AAPT. The cash purchase price was approximately \$2.2 billion, which included a payment for goodwill of about \$1.8 billion. Like the Vodafone and The Warehouse examples, Telecom subsequently amortised this goodwill till 2006 when all the remaining goodwill (\$844 million) was impaired. A further \$447 million was impaired against the other assets of the subsidiary and Telecom's income in 2006 was affected by the total impairment of \$1.29 billion.

EFFECTS OF ADOPTING IAS 38

Although *IAS 38* was issued in 1998, it did not have an immediate effect on accounting practice as most countries were not bound by its provisions. However, the move by regulators to adopt international accounting standards means that many countries have adopted *IAS 38* for financial years starting in 2005. New Zealand reporting entities must adopt the international standards for years beginning in 2005 to 2007. An immediate effect of adopting *IAS 38* is being felt by firms that previously capitalised internally generated brands and other intangibles like mastheads, publishing titles and customer lists, which are specifically excluded from recognition by *IAS 38*. These firms are required to "de-recognise" these assets when *IAS 38* is adopted, sometimes with adverse financial effects.

For example, in the year ended 30 September 2005, Lion Nathan's net assets or equity dropped to \$A881.7 million when brand assets were removed from the balance sheet. This is \$A1,611.8 million lower than the \$A2,493.5 million that would have been reported in the absence of *IAS 38*,¹⁴ which lends support to the claim that relevant information will be lost by adopting *IAS 38*.¹⁵

In addition, adjustments need to be made to the previously recognised intangible assets like goodwill and most acquired intangibles that remain in the balance sheet after the adoption of *IAS 38*. As goodwill (and some other assets) have indefinite lives, amortisation on these assets will cease with a consequent rise in income. This factor could be overshadowed by the possible impairment of these assets. In Lion Nathan's case, the cessation of goodwill amortisation increased group profit by \$A8.0 million in the year ended 30 September 2005.

Another longer term effect may be a further increase and reliance on the use of non-financial indicators (NFI). These are, as the name suggests, measures of performance that do not rely overly on financial data. One commentator¹⁶ has observed "investors are likely to find NFIs particularly helpful when appraising companies rich in intangibles. In these cases, traditional financial statements may be misleading: expenditures on intangibles are expensed as incurred and net assets of growing companies are understated". The use of NFI's was illustrated in a study¹⁷ which looked at valuation issues connected with mobile phone companies. The study found that equity values of these companies were related to NFIs like population of the licence areas (POPS) and the penetration ratio (the ratio of subscribers to POPS), which may suggest that the market is seeking information from other sources when accounting numbers become less useful.

CONCLUSIONS

Intangible assets have unusual measurement and recognition features which have made it difficult to develop a comprehensive accounting standard. The issue of *IAS 38* in 1998 and its subsequent adoption by many countries from 2005 including New Zealand from 2005-2007 represents an attempt to impose a uniform set of rules on what had become an increasingly contentious and differentiated reporting environment. The approach of the standard follows that of the earlier research and development promulgations and imposes strict limits on the recognition of some assets, especially internally generated intangibles. The argument that there is a lack of a relation between the cost of the intangible assets and specific future revenues is also applicable to most property, plant and equipment assets. *IAS 38* clearly excludes internally generated intangibles by rule rather than applying its recognition and reliability tests to these assets. Clearly the standard setters do not trust the valuation of intangible assets. Some relief is provided by the increased opportunities to recognise intangibles in other situations, for example in business combinations.

Some of the provisions of *IAS 38* are contrary to the

Accounting standard setters are aware of the potential information gaps in the reporting of intangible assets.

Stay Ahead in Business

Short Courses

The University of Auckland

NZ's No. 1 University*



A Short Course from The University of Auckland Business School is your road to new knowledge and skills.

New Zealand's No.1 University offers over 300 two day Short Courses, all of which are designed to help you stay ahead in business.

Developed with your needs in mind, Short Courses are practical and punchy. They are taught by industry experts and allow you to upskill alongside like-minded business and professional people.

Call 0800 800 875 or visit www.shortcourses.ac.nz for a calendar.



0800 800 875 | www.shortcourses.ac.nz



*Times Higher Education Supplement's 2006 world university rankings

established practices of some large firms and multi-nationals. These firms have been required to make major changes to their financial statements to reverse previous policies like the capitalisation of self-generated intangibles which no longer qualify as assets. Some of these companies, like Lion Nathan and APN advocated strongly, to no avail, against the exclusion of their capitalised brands, mastheads and publishing titles using the argument that they provided relevant information that was also reliable.

Accounting standard setters are aware of the potential information gaps in the reporting of intangible assets both before and after the adoption of *IAS 38*. For example, the US Financial Accounting Standards Board added an enquiry “Disclosure of Information About Intangible Assets Not Recognised in Financial Statements” to its technical agenda in 2002. In similar vein, the International Standards Accounting Board has noted deficiencies and weaknesses in the guidance given by *IAS 38*.

References

1. Lev, B. (2001). *Intangibles: Management, Measuring and Recording*. Washington, DC.: Brookings Institution Press. p5.
2. Reliability refers to information which is free from material error and bias and faithfully represents the entity's transactions and events. There is no emphasis on whether the reliably recorded information is useful to the users of the financial statements. Relevance exists when the information influences the economic decisions made by users of financial statements.
3. For example, in 1904 the US economist Thorstein Veblen commented 'The substantial foundation of the industrial corporation is its immaterial assets' which he recognized consisted of intangible assets but thought that 'there may be peculiar difficulties in the way of reducing this goodwill to the form of a fund, expressing it in terms of a standard unit'. In Veblen, T. (1904) *The Theory of Business Enterprise*. New Brunswick, N.J.: Transaction Books, c1973.
4. Lev, B. (2001). *Intangibles: Management, Measuring and Recording*. Washington, DC: Brookings Institution Press.
5. Though originally a New Zealand company, Lion Nathan has been overseas owned since the 1980's and is now domiciled in Australia. It is a major Australasian distilling, beer and wine company.
6. Lev, B. & Zarowin, P. (1999). The Boundaries of Financial Reporting and How to Extend Them. *Journal of Accounting Research*, 33(2), 353-386.
7. Upton, W.S. (2001). *Business and Financial Reporting, Challenges From the New Economy* (Financial Accounting Series Special Report). Norwalk, Connecticut: Financial Accounting Standards Board,
8. Lev, B. (2001). See endnote 4.
9. Lev, B. (2001). p9. See endnote 4.
10. The New Zealand Institute of Chartered Accountants issued the *Statement of Concepts for General Purpose Financial Reporting* in 1993, which was similar to conceptual statements issued by Australia, the UK, the US, and the International Accounting Standards Board. All contained comparable definitions of assets and criteria for the recognition of assets in the balance sheet.
11. Other Australian companies, especially publishers and media companies, followed Lion Nathan's example. With the advent of *IAS 38*, these companies have been required to derecognise their internally generated intangibles.
12. New Zealand reporting entities must adopt international accounting standards between 2005 – 2007. The local versions of the standards are called *New Zealand International Accounting Standards (NZ IAS)*. Australia and most of Europe adopted international accounting standards for financial years beginning in 2005. The US has no immediate plans to adopt the standards, though there is a 'convergence' program to align US and international accounting standards.
13. An asset may be impaired when its *recoverable amount* (which is its market value or the present value of the asset's cash flows whichever is the higher) falls below the balance sheet value of the asset. The asset is written down to its impaired value and an expense is recognised.
14. Lion Nathan published its pre-*IAS 38* financial statements in 2005. The adjustments cited are the restated comparative figures for the 2005 year which will be used in the 2006 balance sheet. The first full set of accounts complying with all international accounting standards will be published for the year ended 30 September 2006.
15. Mathews, M.R., & Higson A.W. (2000). *Potentially Dysfunctional Impacts of Harmonising Accounting Standards: The Case of Intangible Assets*. (Discussion Paper series No. 199), Massey University School of Accountancy.
16. Sutton, T. (2004). *Corporate Financial Accounting and Reporting*. (2nd ed), Harlow, England: Prentice Hall. p218.
17. Amir, E., & Lev, B. (1996). Value Relevance of Nonfinancial Information: The Wireless Communications Industry. *Journal of Accounting and Economics*. 17, 3-30.