

1 Intangible assets and goodwill (Lecture A684 – 18.24 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with the issue of intangible assets (but not goodwill) at Section 18 *Intangible Assets other than Goodwill*. Unlike old UK GAAP, goodwill is not dealt with in the intangible assets section, instead it is dealt with in Section 19 *Business Combinations and Goodwill*.

Intangible assets tend to cause some complexities because sometimes they can be extremely subjective items to account for and over the last couple of years some questions have begun to emerge concerning the accounting treatment of certain items under FRS 102. In addition, we will also consider some of the changes that have been made to the accounting for intangible assets other than goodwill as part of the Financial Reporting Council's triennial review of UK GAAP which completed in December 2017.

1.1 Definition of an intangible asset

FRS 102 defines an 'intangible asset' as:

*An identifiable non-monetary asset without physical substance. Such an **asset** is identifiable when:*

*FRS 102 Glossary
intangible asset*

- (a) *it is 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**; or*
- (b) *it 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.*

It follows, therefore, that all assets which are separable are identifiable. Separability is not, however, the only indication of identifiability. An asset which arises from contractual or legal rights can also be identifiable.

Example – Separable asset

Peter runs his own taxi company in the UK and needs a taxi licence in order to operate his taxi.

The taxi licence would be regarded as an identifiable asset because it is needed to operate the vehicle, hence is a critical aspect of his business and it also arises from legal rights despite the fact that the licence would not usually be separable from the underlying business as it would only be transferable to other taxi operators.

1.2 Scope of Section 18

FRS 102, Section 18 does not apply to:

- (a) **financial assets** (see Section 11 Basic Financial Instruments and Section 12 Other Financial Instruments Issues); FRS 102 para 18.3
- (b) **heritage assets** (see Section 34 Specialised Activities);
- (c) exploration for and evaluation of mineral resources, such as oil, natural gas and similar non-regenerative resources (see Section 34) and expenditure on the development and extraction of such resources; or
- (d) **deferred acquisition costs** and intangible assets arising from contracts in the scope of **FRS 103**, except for the disclosure requirements in this section which apply to intangible assets arising from contracts within the scope of FRS 103.

1.3 Recognition and measurement

Care needs to be taken not to inappropriately recognise intangible assets on a company's balance sheet. For example, internally generated goodwill is strictly prohibited under FRS 102, paragraph 18.8C(f) (as was the case in FRS 10 *Goodwill and intangible assets* and the FRSSE). Over the years some entities have recognised internally generated goodwill on the balance sheet in contravention of accounting standards which invariably presents a misleading position. If a company purchases goodwill, then that purchased goodwill can be recognised on the balance sheet at cost.

Paragraph 18.4 of FRS 102 says that an entity shall recognise an intangible asset if, and only if:

- (a) it is **probable** that the expected future economic benefits that are attributable to the asset will flow to the entity; and FRS 102 para 18.4 (a) and (b)
- (b) the cost or value of the asset can be measured reliably.

Internally generated goodwill fails test (b) because there is no reliable measure of cost, generally because there is no 'active market' from which to derive a reliable measure of cost. The term 'active market' is defined in the Glossary to FRS 102 as:

A market in which all the following conditions exist:

*FRS 102 Glossary
active market*

- (a) the items traded in the market are homogeneous;
- (b) willing buyers and sellers can normally be found at any time; and
- (c) prices are available to the public.

Simply obtaining a valuation of goodwill from an accountancy firm does not mean it can be recognised on the balance sheet as there is still no active market.

Ordinarily, goodwill will only arise in a business combination under FRS 102, hence it being placed in Section 19 *Business Combinations and Goodwill*.

1.4 Software and website development costs

An issue which is generating debate is the classification of software and website development costs. FRS 102 does not address the classification of software and website development costs and therefore in the absence of specific guidance, reporting entities are required to develop and apply a suitable accounting policy to classify such costs as either tangible or intangible fixed assets. FRS 102, para 10.5 provides a hierarchy of sources which are to be referred to (in descending order) in developing this policy.

Software and website costs which are being developed internally are dealt with under Section 18 of FRS 102 as research and development costs (para 18.8H). All research expenditure (pure and applied) must be written off to profit or loss as expenditure; there is no option at all to capitalise research expenditure. This is because in the research phase of a project, an entity will be unable to demonstrate that an intangible asset exists which will generate probable future economic benefits.

Once the research phase has completed and the project has been moved into the development phase, the entity may recognise software and website development costs if, and only if, an 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.*

FRS 102 para 18.8H
(a) to (f)

Micro-entities reporting under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* cannot capitalise any development costs; all such costs are written off to the profit and loss account as incurred. This is because the capitalisation of development costs is an accounting policy choice under UK GAAP and micro-entities reporting under FRS 105 have no accounting policy choices available to them.

Accounting treatment: website development costs

Website development costs should only be capitalised if they meet the recognition criteria of an asset; one of those criteria being that *'it is probable that the expected future economic that are attributable to the asset will flow to the entity'*.

To assess whether costs qualify for recognition on the balance sheet, the entity must look at the overall functionality of the website. If the website will allow third parties to place orders for goods or services, then this creates a revenue stream for the business (i.e. economic benefit). Provided the cost can be measured reliably and none of the expenditure relates to research costs, then the website may be capitalised on the balance sheet as an intangible asset and amortised over its useful economic life. **Please note that under FRS 102, intangible assets cannot have indefinite useful lives** (see 'Amortisation of intangible assets' below).

If the website does not generate income for the business, then it will fail to meet the asset recognition criteria and the costs of the website must be written off to profit or loss.

Care must be taken with the accounting treatment for website development costs because mistakes can be costly (especially if the incorrect tax treatment is applied).

Accounting treatment: software costs

When software costs meet the recognition criteria for an asset, again consideration must be given as to the type of software being capitalised. If the software is not critical for the hardware to operate then the software should be capitalised as an intangible fixed asset. However, if the software is a critical aspect of enabling the hardware to work (for example, an operating system), then the software costs are capitalised as part of the hardware, i.e. as a tangible fixed asset.

Regardless of whether the software is capitalised as an intangible asset or a tangible asset, the software must be amortised or depreciated over its useful economic life.

1.5 Initial measurement (separately acquired intangible assets)

FRS 102, para 18.9 requires an entity to measure an intangible asset initially at cost. Para 18.10 confirms that the cost of a separately acquired intangible asset comprises:

- (a) *its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and*
- (b) *any directly attributable cost of preparing the asset for its intended use.*

*FRS 102 para 18.10
(a) and (b)*

Examples of 'directly attributable costs' include:

- legal and professional fees;
- costs of testing whether the intangible asset is functioning correctly; and payroll costs of individuals employed by the entity who are directly engaged in bringing

the intangible asset to its working condition. Internally generated intangible assets

In practice, it is often difficult to justify recognising internally generated assets and those that are recognised will usually be restricted to specific situations relating to development expenditure where the entity has a policy of capitalising development costs.

FRS 102, para 18.10A states that the cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria in FRS 102, paras 18.4 and 18.8H.

FRS 102, para 18.10B then goes on to state that the cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce and prepare the intangible asset to be capable of operating in the manner intended by management. Paragraph 18.10B provides the following examples of directly attributable costs:

- (a) *costs of materials and services used or consumed in generating the intangible asset;*
 - (b) *costs of **employee benefits** (as defined in Section 28 Employee Benefits) arising from the generation of the intangible asset;*
 - (c) *fees to register a legal right; and*
 - (d) ***amortisation** of patents and licences that are used to generate the intangible asset.*
- FRS 102 para 18.10B (a) to (d)*

It must be emphasised that FRS 102, para 18.17 states that expenditure on an intangible item which was initially recognised as an expense must not be recognised at a later date as part of the cost of an asset.

Example – Distinguishing between the research phase and development phase of an internal project

An entity is developing a new accounts production system for accountants in poorer overseas countries to help them become more efficient in the way that they prepare financial statements and undertake other assignments for their clients.

The project team have structured the project as follows:

1. Identify the need for a new accounts production system.
2. Commission research for any existing equivalent accounts production system in that part of the world.
3. Commission research for any existing equivalent accounts production systems that may have features which the entity believe are currently only unique to themselves.
4. Undertake research for any other competitors which may be involved in producing equivalent accounts production systems in the timescale which the project team have devised.
5. Commission the design of the new accounts production system.
6. Prepare a shortlist from step 5 above.
7. Obtain a budget from the finance department for the new system and then compare this budget to the shortlist prepared in step 6.
8. Prepare a further shortlist of two possible alternatives based on feedback from the project management team.
9. Send the final two shortlisted candidates to the board of directors for their approval.
10. Develop the new accounts production system.
11. Undertake testing.
12. Roll out the new system.

The recognition criteria at each stage should be considered in order to establish when capitalisation of development costs can commence and hence when the recognition criteria has been met. At stage 5 of the project, the technical feasibility of completing the project has been confirmed. At the end of stage 7 it has been established how the project will generate future economic benefits. At the beginning of stage 10 all of the recognition criteria have been met and the board of directors have approved the project which, in turn, provides evidence of the company's intention to complete the project. The budgeted information will also provide evidence of the entity's ability to measure the expenditure.

1.6 Subsequent measurement

FRS 102, Section 18 allows for two subsequent measurement bases:

- the cost model; and
- the revaluation model.

Cost model

After initial recognition, the entity measures the intangible asset at cost less accumulated amortisation (see 2.7 below) and accumulated impairment losses.

Revaluation model

Under the revaluation model, an intangible asset whose fair value can be measured reliably is carried at a revalued amount, less subsequent amortisation and impairment. Fair value will need to be obtained by reference to an active market.

While Section 18 does allow the revaluation model for intangible assets, in practice the model is rarely used. This is because it is rare for an active market to exist for intangible assets other than for items such as taxi licences and production quotas. There are some important points to note where the revaluation model for intangible assets is concerned:

- the revaluation model can only be applied that have previously been recognised as intangible assets; it cannot be applied to intangible assets that have previously been expensed; and
- the revaluation model can only be applied to those intangible assets which have been initially recognised at cost. Hence, for an intangible asset acquired as part of a business combination, 'cost' means fair value at the date of acquisition. The revaluation model cannot be applied to intangible assets which have been initially recognised at amounts other than cost.

The revaluation model in Section 18 works in the same way as the revaluation model in Section 17 (see 1.4 above).

1.7 Amortisation

Under FRS 102, all intangible assets have finite useful lives. It is no longer permissible to carry intangible assets with indefinite useful lives as it was under previous FRS 10 and the FRSSE.

FRS 102, para 18.19 says that the useful life of an intangible asset which has arisen from contractual or other legal rights must not exceed the period of the contractual or other legal rights. However, it may be shorter depending on how long the entity expects to use the intangible asset.

FRS 102, para 18.20 places a cap of 10 years on amortisation **in exceptional cases only**. This 10-year rule has caused an element of confusion because some

accountants believe this to be a maximum period for **all** intangible assets, which is not the case.

Paragraph 18.21 of FRS 102 says that intangible assets are amortised on a systematic basis over their useful lives. It would not be unreasonable for certain intangible assets to have a longer life than 10 years and as long as management can provide evidence to support their assessment of that useful life, it would be acceptable to amortise the intangible assets over that said period. The 10-year rule in FRS 102 is triggered when management are unable to make a reliable estimate of the useful life of an intangible asset. The 10-year cap is a maximum, not a minimum – therefore management may determine a five-year amortisation period to be appropriate or even less.

Residual values

FRS 102, para 18.23 states that an entity must assume that the residual value of an intangible asset is zero unless:

- (a) *there is a commitment by a third party to purchase the asset at the end of its useful life; or*
- (b) *there is an active market for the asset and:*
 - (i) *residual value can be determined by reference to that market; and*
 - (ii) *it is probable that such a market will exist at the end of the asset's useful life.*

*FRS 102 para 18.23
(a) and (b)*

1.8 Review of amortisation period and amortisation method

FRS 102, para 18.24 recognises that factors such as a change in how an intangible asset is used, technological advancements and changes in market prices may influence residual values and useful lives of intangible assets. If such indicators are present, FRS 102, para 18.24 requires management to review its previous estimates and, if current expectations differ, amend the residual value, amortisation method or useful life as appropriate. Such amendments are changes in estimation and hence are accounted for prospectively in accordance with FRS 102, Section 10 *Accounting Policies, Estimates and Errors*. No retrospective restatement is needed.

1.9 Impairment of intangible assets

As noted earlier, assets cannot be carried in the balance sheet in excess of recoverable amount and this principle applies to fixed assets (i.e. tangible and intangible) also. This does not mean, in practice, that an impairment calculation has to be carried out at each balance sheet date; FRS 102 only requires an *assessment* of whether there are any indicators of impairment. If there are indicators of impairment, then recoverable amount of the asset must be calculated and compared to carrying values. Where the carrying amount of a fixed asset exceeds recoverable amount, the fixed asset is impaired and is written down to recoverable amount.

1.10 Changes to Section 18 arising from the FRC's triennial review

The definition of an intangible asset in FRS 102 is different than under previous UK GAAP and gave rise to the need to recognise additional intangible assets that were acquired in a business combination (i.e. where a parent acquires a subsidiary). This increased costs of compliance in some instances, which the FRC have recognised goes against the principles of standard-setting.

The FRC decided to amend Section 18 *Intangible Assets other than Goodwill* as part of the triennial review so as to provide entities with an accounting policy choice of either separately recognising intangible assets acquired in a business combination or including them within goodwill. If the entity chooses to separately recognise intangible assets, they must apply this policy to all intangible assets in the same class and on a consistent basis.

Note – as the changes to Section 18 arose from the triennial review, they are effective for accounting periods commencing on or after 1 January 2019. Early adoption is permissible provided all of the triennial review amendments are applied at the same time. The exception to this early adoption rule is in respect of the directors' loan simplification (for small entities) and the tax effects of gift aid payments amendment.

FRS 102, para 18.8 in the March 2018 edition of the standard states:

*Intangible assets acquired in a **business combination** shall be recognised separately from goodwill when all the following three conditions are satisfied:*

FRS 102 para 18.8

- (a) *the recognition criteria set out in paragraph 18.4 are met;*
- (b) *the intangible asset arises from contractual or other legal rights; and*
- (c) *the intangible asset is 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**).*

An entity may additionally choose to recognise intangible assets separately from goodwill for which condition (a) and only one of (b) or (c) above is met. When an entity chooses to recognise such additional intangible assets, this policy shall be applied to all intangible assets in the same class (ie having a similar nature, function or use in the business), and must be applied consistently to all business combinations. Licences are an example of a category of intangible asset that may be treated as a separate class, however, further subdivision may be appropriate, for example, where different types of licences have different functions within the business.

The effect of the above is to reduce the costs of compliance of having to separately recognise intangible assets acquired as part of a business combination. Reporting entities can continue to separately recognise such intangible assets if they wish, provided this accounting policy is applied consistently to all intangible assets in the same asset class.

It must also be noted that where the entity does adopt a policy of recognising intangible assets separately from goodwill, paragraph 18.28A requires the acquirer to disclose the nature of those intangible assets and the reason why they have been separated from goodwill.