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Intangible Assets Recognition: Whether the Recognition Criteria Should Be Expanded

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Abstract: Intangible assets are hailed as the core competence by companies. In order to adapt to this situation, whether the recognition requirement of intangible assets should be expanded is discussed critically in this report. The necessity of expansion of recognition criteria is conferred from two aspects: the advantages and disadvantages of expansion.

1. Introduction

With the vast development in technology industries, intangible assets have gradually become a crucial part for the entities and stakeholders to pay attention to. Although the recognition criteria of intangible assets are clearly defined, deficiencies resulting from the omissions of such assets have become more frequent and serious. Furthermore, the necessity to expand the requirements for recognizing intangibles in the balance sheet is one of the most bitterly discussed accounting questions.

This report will first focus on universal requirements for recognizing intangible assets. Then, the question of whether accounting standards should seek to expand the recognition requirements for such assets in the balance sheet will be critically evaluated.

2. Interpretation of Exiting Recognition Requirements for Intangible Assets

According to the International accounting standard (IAS) 38 intangible asset is defined as "an identifiable non-monetary asset without physical substance, controlled by the entity as due to past events, having the power to obtain future economic benefits from the asset" (IFRS, 2004). Additionally, an identifiable intangibles asset should appease basic terms that it is separable and originates from contractual or other legal rights. (Iasplus.com, 2020) This definition highlights the characteristics of intangible assets that enable them to be distinguished from other forms of assets; in particular property, plant and machinery, and accounts receivable.

Also, IAS 38 sets out the universal recognition criteria that an intangible is recognized only if future economic benefits attributable to this asset are proposed to flow to the entity probably, even if the timing and the amount of the inflow are uncertain, and its costs can be measured reliably (IFRS, 2004).

Particularly, the future economic benefits from an intangible are assessed under the principle in IAS36 (IFRS, 2013). From this point of view, an intangible item is highly likely to be recognized only if the definition and the universal recognition requirements are both complied with. However, under IAS 38, different categories of intangible assets are subjected to additional criteria and various measurement methods.

Separately acquired intangibles that can be recognized as intangible assets by acquirers should satisfy those two general criteria mentioned previously. In addition, the cost of a separately acquired intangible asset consists of two parts: the purchase price and directly attributable costs which bring the asset to its working condition (IFRS, 2004). The purchase price mainly includes "import duties and non-refundable purchase taxes, after deducting trade discounts and rebates". Moreover, directly attributable costs are regarded as "any directly attributable cost of preparing the asset for its intended use" (Iasplus.com, 2020), such as the costs of testing intangibles.

An intangible asset, such as a trademark and a patent acquired through a business combination should be recognized as assets distinct from goodwill (Doupnik et al., 2012) and measured at its fair value at the acquisition date, reflecting the feature of inflow economic benefits in the future and a reliable costs measurement. To be more precise, the probability requirement is satisfied if the asset engenders economic benefits to the entity in the foreseeable future and reliability requirement is also applicable under the circumstance that sufficient information exists for measuring the fair value of the asset accurately (IFRS, 2004). However, these two additional conditions were deleted since it is concluded that they will always be satisfied in a business combination in 2008. (Iasplus.com, 2018)

The recognition requirements for internally-generated assets, however, requires more thought. IAS 38 stipulates the need for simultaneous compliance with these two universal recognition requirements mentioned above. However, these two recognition criteria are difficult for an entity to assess in reality. To recognize an intangible asset definitively, IAS 38 classifies a development project and research into a research phase and a development phase (Iasplus.com, 2020). If these two phases cannot be separated distinctly, all expenditure on the project should be treated as in a research phase (IFRS, 2004).

Since the research could be invalid at an early stage, it is highly uncertain whether an identifiable asset will be established successfully and whether an established identifiable asset will generate future economic benefits. Therefore, during the research phase, no intangible asset will be recognized. Research expenditure should be regarded as an expense in the income statement instead of being capitalized as an intangible when it is incurred (Accaglobal.com, n.d.). During the development phase, an advanced stage of a project, a company can recognize an intangible asset generated internally if it meets six recognition criteria. These criteria formulate the recognition of an asset from the feasibility of completing, its intention to completing and use or sell, its ability to use or sell, the way assets generating benefits, the availability of resources and the reliable measurement (IFRS, 2004). In other words, the development expenditures can be capitalised when a company can demonstrate all of these criteria. In order to assure those recognition requirements are still satisfied in each accounting period, all development projects must be reviewed.

It is worth mentioning that internally generated goodwill is not recognized as an intangible asset on account of its being not an identifiable resource controlled by the entity that can be measured reliably at cost. Furthermore, if the costs of internally generated intangibles cannot satisfy either the research or development criteria, they should be expensed and regarded as research expenditure, such as 'seasonal design changes to existing products' or 'routine design of tool'.

3. Discussion of Whether the Recognition Requirement of Intangible Assets Should be Expanded

Although the recognition criteria for intangible assets are clarified in detail under IAS 38, there is still no consensus regarding whether the requirements should be broadened. While the current recognition requirements have several defects that lessen their effectiveness and affect users' understanding, the expansion of the requirements for the recognition of intangible assets in the balance sheet strongly requires serious consideration. This essay will elaborate on both the positive and negative effects of such an expansion accordingly.

Some experts believe that the expansion of recognition criteria will better reflect the actual value of an entity. Under IAS 38, internally generated intangibles, such as customer lists, brands, and logos, are not separately recognized in the balance sheet. The costs of these intangible assets cannot be separated from the normal costs or business operation costs, so it is difficult to measure the value of these assets reliably. However, entities' bands, knowledge, and skilled staff constitute a profitable and strong business force. They are regarded as the most valuable assets of large companies. Therefore, companies spend a huge amount of money on these assets. On the consumers' side, they have an emotional attachment to intangible assets such as brands and logos as well, which gives value to these assets. One can see that recognizing these intangibles assets separately on the balance sheet provides users with more specific information about intangible assets in which they have an

interest, because it provides some insight into the reasons for acquisition and the major value drivers of the acquirer(Iasplus.com, 2016). What’s more, a higher accounting discretion for intangible asset recognition is beneficial to the entity and the accounting information users. Specifically, limiting the recognition of intangible assets may result in a reduction in the informativeness of the balance sheet provided by the entity to the stakeholders (Wyatt, 2005).

However, the implications of expanding recognition requirements for intangible assets for users and entities are twofold. There is an increasing concern regarding the correlation and reliability of the value measurement as more intangible assets are identified on the balance sheet. It may lead to inauthentic financial reports and manager creation. The reporting of intangibles is 'forward-looking', and management for estimating intangibles could be subject to biases and manipulative (Uzma, 2012). Expanding the recognition requirement will lead to widespread manipulation fraud in financial reporting. Also, any formulae for valuing assets that are untouchable and invisible involves subjective judgment to some extent, especially when it involves prospects for the future.

Secondly, assessing and identifying these intangible assets is time-consuming and costly. Professional fees may be attached due to the need to employ specialists. A large number of companies are not willing to complete this thankless task, or they don’t have the time and resources for it, particularly the start-ups. This may also make the audit more difficult and lead to an increase in audit fees. From this perspective, the generated costs far outreach the potential benefits.

Furthermore, the income statement fills the gap between the balance sheet assets and the market value of a business. More specifically, earnings generating from intangibles will be shown in the income statement (PENMAN, 2009). For example, the Coco Cola's brand is not measured on the financial statement, while the earnings caused by the brand are shown in the income statement. The income statement gives a more appropriate indication of the value of intangibles assets since it measures the benefits generated from all sources of tangibles assets.

Although some specialists agree that expanding recognition criteria is optimal, they raise concerns. Winters, N., an audit partner at PKF, concluded that including brand values and other intangibles on the balance sheet may lead to sharp fluctuations in a company's asset value and profit annually (Accountancydaily.co, 2002). Wild, K., technical partner at Deloitte & Touche, stated that encourage management to concentrate on achieving target rather than focusing on the interests of the business (Accountancydaily.co, 2002).

4. Conclusion

In the era of a knowledge economy, the status and role of intangible assets should be monitored and improved constantly. Faced with fierce market competition, many companies, especially in the technology industry and Internet industry, consider intangible assets as their core competitiveness. Therefore, investors and entities have gradually expanded more effort and directed attention towards understanding intangible assets, of which the recognition requirement comprises one of the essential elements necessary for their full comprehension.

Universal definitions and recognition requirements apply to all categories of intangible assets under IAS 38. Nonetheless, recognition requirements for the intangible assets differ slightly among those diverse categories.

Expansion of recognition requirement has been subjected to criticism for different reasons and agreement and there is yet no consensus or established explanation about this issue. Expanding the recognition criteria may remedy the deficiencies of the balance sheet that do not value all sources of assets in an entity. On the contrary, expansion of the recognition requirement of intangibles may induce manipulation and fraud of the balance sheet, increase operating costs of an entity, lead to sharp fluctuations in a company's asset value and profit from year to year and mislead management into being after achieving target instead of benefits. Additionally, the income statement shows the benefits generated from intangibles judiciously.

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