

CHAPTER 17

R&D; goodwill; intangible assets and brands

17.1 Introduction

The main purpose of this chapter is consider the accounting treatments of:

- research and development;
- goodwill and other intangible assets;
- brands; and
- emissions trading certificates.

Objectives

By the end of this chapter, you should be able to:

- define and explain how to account for research and development (R&D), goodwill and other intangible assets;
- comment critically on the IASB requirements in IAS 38 and IFRS 3;
- account for development costs;
- account for impairment;
- prepare extracts of the entries and disclosure of these items in the statement of comprehensive income and statement of financial position.

17.2 Accounting treatment for research and development

Under IAS 38 *Intangible Assets*,¹ the accounting treatment for research and development (R&D) differs depending on whether the expenditure relates to research expenditure or development expenditure. Broadly speaking, research expenditure must always be charged to the statement of comprehensive income and development expenditure must be capitalised provided a strict set of criteria is met. In this section we will consider how R&D is defined, why research expenditure is written off and the tests for capitalising development expenditure.

17.3 Research and development

IAS 38 *Intangible Assets* defines both research and development expenditure.

17.3.1 Research defined

IAS 38 states² ‘expenditure on research shall be recognised as an expense when it is incurred’. This means that it cannot be included as an intangible asset in the statement of financial position. The standard gives examples of research activities³ as:

- 1 activities aimed at obtaining new knowledge;
- 2 the search for, evaluation and final selection of, applications of research findings or other knowledge;
- 3 the search for alternatives for materials, devices, products, processes, systems and services;
- 4 the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Normally, research expenditure is not related directly to any of the company’s products or processes. For instance, development of a high temperature material, which can be used in any aero engine, would be ‘research’, but development of a honeycomb for a particular engine would be ‘development’. Whilst it is in the research phase, the IAS position⁴ is that an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. It is this inability that justifies the IAS requirement for research expenditure not to be capitalised but to be charged as an expense when it is incurred.

17.3.2 Development defined

Expenditure is recognised⁵ as development if the entity can identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. The standard gives examples of development activities:⁶

- (a) the design, construction and testing of pre-production and pre-use prototypes and models;
- (b) the design of tools, jigs, moulds and dies involving new technology;
- (c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production;
- (d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

17.4 Why is research expenditure not capitalised?

Many readers will think of research not as a cost but as a strategic investment which is essential to remain competitive in world markets. Indeed, this was the view⁷ taken by the House of Lords Select Committee on Science and Technology, stating that ‘R&D has to be regarded as an investment which leads to growth, not a cost’. Globally, such expenditure is in excess of 3% of sales, taking place particularly in the advanced technical industries such as pharmaceuticals, where a sustained high level of R&D investment is required – almost 80% occurring in five countries: the USA, Japan, Germany, France and the UK. The regulators, however, do not consider that the expenditure can be classified as an asset for financial reporting purposes.

Why do the regulators not regard research expenditure as an asset?

The IASC in its *Framework for the Preparation and Presentation of Financial Statements* (para. 49) defines an asset as a resource that is controlled by the enterprise, as a result of past events and from which future economic benefits are expected to flow.

Research is controlled by the enterprise and is as a result of past events but there is no reasonable certainty that the intended economic benefits will be achieved. Because of this uncertainty, the accounting profession has traditionally considered it more prudent to write off the investment in research as a cost rather than report it as an asset in the statement of financial position.

It might be thought that this is concealing an asset from investors but in research on both analysts⁸ and accountants⁹ reactions to R&D expenditure Nixon¹⁰ found that: ‘Two important dimensions of the corporate reporting accountants’ perspective emerge: first, disclosure is seen as more important than the accounting treatment of R&D expenditure and, second, the financial statements are not viewed as the primary channel of communication for information on R&D.’

This highlights the importance of reading carefully the narrative in financial reports. An interesting study in Singapore¹¹ examined the impact of annual report disclosures on analysts’ forecasts for a sample of firms listed on the Stock Exchange of Singapore (SES) and showed that the level of disclosure affected the accuracy of earnings forecasts among analysts and also led to greater analyst interest in the firm.

Management might prefer in general to be able to capitalise research expenditure but there could be circumstances where writing off might be preferred. For example, directors might be pleased to take the expense in a year when they know its impact rather than carry it forward. They are aware of profit levels in the year in which the expenditure arises and could, perhaps, find it embarrassing to take the charge in a subsequent year when profits were lower or the company even reported a trading loss.

Development expenditure, on the other hand, has more probability of achieving future economic benefits and that allows it to be classified as an asset. The regulators, therefore, require such expenditure to be capitalised.

17.5 Capitalising development costs

IAS 38 now requires development costs to be capitalised. However, that has not always been the situation. The development of an accounting standard in this area has been subject to the conflicting demands of the accruals concept (which would favour capitalisation if future benefits could be foreseen) and the prudence concept (which would favour immediate write-off). This led to a compromise whereby companies were allowed a choice of either capitalising or expensing. This element of choice impaired inter-company comparisons and was seen by many analysts as a significant weakness. The IASC responded to this concern and in its *Statement of Intent: Comparability of Financial Statements*,¹² proposed that the choice should be removed and that, if development costs met the conditions for capitalisation, they must be capitalised and depreciated. This is the approach that has since been adopted by IAS 38.¹³

17.5.1 The conditions set out in IAS 38

The relevant paragraph of IAS 38 (para. 57) says an intangible asset for development expenditure must be recognised 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) the 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;

- (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.

It is important to note that if the answers to all the conditions (a) to (f) above are ‘Yes’ then the entity *must* capitalise the development expenditure subject to reviewing for impairment. For example, if costs incurred exceed future economic benefits, the lower figure is taken and the difference written off. There is a large element of judgement and if a company does not want to capitalise its development expenditure, it could argue that there is sufficient uncertainty about future development costs, being able to develop the product and/or making profits from future sales, and thus answer ‘No’ to one of the questions above. This would result in development expenditure not being capitalised.

17.5.2 What costs can be included?

The costs that can be included in development expenditure are similar to those used in determining the cost of inventory (IAS 2 *Inventories*). It is important to note that only expenditure incurred after the project satisfies the IAS 38 criteria can be capitalised – all expenditure incurred prior to this date must be written off as an expense in the statement of comprehensive income.

How is the amortisation charge calculated?

The intangible asset of development costs is usually amortised over the sales of the product (i.e. the charge in 20X5 would be: 20X5 sales/total estimated sales × capitalised development expenditure).

17.6 The judgements to be made when deciding whether to capitalise development costs

The IASB’s *Framework for the Preparation and Presentation of Financial Statements* says ‘an asset is recognised in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably’. Let us consider these conditions further.

17.6.1 Cost incurred to date

Costs such as wages and materials can generally be measured reliably although there might be arguments as to the amount of overheads that can be allocated or apportioned to the development activities. This would be a matter for the auditors to satisfy themselves as to the justification for the overhead rates applied.

In determining whether ‘it is probable that future economic benefits will flow to the entity’ there could still be uncertainties as to both costs and revenues.

17.6.2 Profit measurement – estimating future costs

Current production wages will be known and might be initially high because of ‘learning’. It might be assumed in estimating future costs that they are likely to reduce when production quantities increase – but by how much? If the economy unexpectedly grows, there could be higher costs. For example, skilled workers might become more expensive to retain,

raw materials such as copper might become more expensive. These factors show how uncertain it is that a product will be profitable, and the potential inaccuracies in estimating this figure.

17.6.3 Profit measurement – estimating future sales

Sales value is the product of the selling price and quantity sold and there may be uncertainties about both of these figures. For some high technology products the selling price might initially be high, but subsequently decline. For instance, high speed microprocessors command a high price when they are released but decline quite quickly as competitors develop faster microprocessors. Also, there is a relationship between quantity sold and the selling price – lowering the selling price will increase sales. This discussion highlights the problems of estimating future sales value.

At what point in time can an asset be recognised?

In the early stages of a development project, usually there are uncertainties over:

- (a) whether the project can be completed successfully; and
- (b) the costs of developing the product.

Experience tends to indicate that people who develop products are notoriously optimistic. In practice, they encounter many more problems than they imagined and the cost is much greater than estimates. This means that the development project may well be approaching completion before future development costs can be estimated reliably. It may, therefore, be very difficult to satisfy the Framework's statement of an asset as being 'recognised in the statement of financial position when it is probable that the future economic benefits will flow to the entity'. If this statement cannot be satisfied, then the development expenditure cannot be included as an asset in the statement of financial position.

17.7 Disclosure of R&D

R&D is important to many manufacturing companies, such as pharmaceutical companies who develop drugs, car and defence manufacturers. Disclosure is required of the aggregate amount of research and development expenditure recognised as an expense during the period.¹⁴ Normally, this total expenditure will be:

- (a) research expenditure;
- (b) development expenditure amortised;
- (c) development expenditure not capitalised; and
- (d) impairment of capitalised development expenditure.

Under IAS 38 more companies may capitalise development expenditure, although many will avoid capitalisation by saying they cannot be certain to make future profits from the sale of the product. The following is the R&D policy extract from the Rolls-Royce Annual Report for the year ended 31 December 2008:

Research and development

In accordance with IAS 38 'Intangible Assets', expenditure incurred on research and development, excluding known recoverable amounts on contracts, and contributions to shared engineering programmes, is distinguished as relating either to a research phase or to a development phase.

All research phase expenditure is charged to the statement of comprehensive income. For development expenditure, this is capitalised as an internally generated intangible

asset, only if it meets strict criteria, relating in particular to technical feasibility and generation of future economic benefits.

Expenditure that cannot be classified into these two categories is treated as being incurred in the research phase. The Group considers that, due to the complex nature of new equipment programmes, it is not possible to distinguish reliably between research and development activities until relatively late in the programme.

Expenditure capitalised is amortised over its useful economic life, up to a maximum of 15 years from the entry-into-service of the product.

The financial statements (of Rolls-Royce for the year ended 31 December 2008) show capitalised development expenditure of £213 million at the year end, £97 million additions and £46 million amortisation in the year.

17.8 Goodwill

IFRS 3 defines goodwill¹⁵ as: ‘future economic benefits arising from assets that are not capable of being individually identified and separately recognised’. The definition effectively affirms that the value of a business as a whole is more than the sum of the accountable and identifiable net assets. Goodwill can be internally generated through the normal operations of an existing business or purchased as a result of a business combination.

17.8.1 Internally generated goodwill

Internally generated goodwill falls within the scope of IAS 38 Intangible assets which states that ‘Internally Generated Goodwill (or “self generated goodwill”) shall not be recognised as an asset’. If companies were allowed to include internally generated goodwill as an asset in the statement of financial position, it would boost total assets and produce a more favourable view of the statement of financial position, for example, by reducing the gearing ratio.

17.8.2 Purchased goodwill

The key distinction between internally generated goodwill and purchased goodwill is that purchased goodwill has an identifiable ‘cost’, being the difference between the fair value of the total consideration that was paid to acquire a business and the fair value of the identifiable net assets acquired. This is the initial cost reported in the statement of financial position.

17.9 The accounting treatment of goodwill

Now that we have a definition of goodwill, we need to consider how to account for it in subsequent years. One might have reasonably thought that a simple requirement to amortise the cost over its estimated useful life would have been sufficient. This has been far from the case. Over the past forty years, there have been a number of approaches to accounting for purchased goodwill, including:

- (a) writing off the cost of the goodwill directly to reserves in the year of acquisition;
- (b) reporting goodwill at cost in the statement of financial position;
- (c) reporting goodwill at cost, amortising over its expected life; and
- (d) reporting goodwill at cost, but checking it annually for impairment.

The first UK accounting standard SSAP 22 *Accounting for Goodwill* was issued in 1984. This allowed entities two alternative treatments:

- 1 write off the goodwill directly to reserves in the year of acquisition (option b); or
- 2 amortise the goodwill to the statement of comprehensive income over its expected life (option c).

Almost all UK companies used treatment 1 above, as it had no effect on reported profit in the current or future years (treatment 2 reduced reported profit because of the amortisation charge). The problem with using treatment 1, however, was that it reduced shareholders' funds, which could become negative. In fact, some advertising agencies reached the situation of having negative shareholders' funds (i.e. the statement of financial position showed the company had negative net worth). As treatment 1 reduces shareholders' funds, it increases the capital gearing of the company (i.e. loans/shareholders' funds) which could lead to a breach of loan covenants making banks and other investors unwilling to provide loans.

17.9.1 The initial IAS 22 treatment

Unlike the UK's SSAP 22, IAS 22 *Business Combinations* (revised 1998) did not allow goodwill to be written off against reserves in the year of acquisition. All companies were required to amortise goodwill over its useful life (option c), thus reducing profits.

17.9.2 The current IFRS 3 treatment

IFRS 3 *Business Combinations* prohibits the amortisation of goodwill. It treats goodwill as if it has an indefinite life with the amount reviewed annually for impairment. If the carrying value is greater than the recoverable value of the goodwill, the difference is written off.

Whereas goodwill amortisation gave rise to an annual charge, impairment losses will arise at irregular intervals. This means that the profit for the year will become more volatile. This is why companies and analysts rely more on the EBITDA (earnings before tax, depreciation and amortisation) when assessing a company's performance, assuming that this is a better indication of maintainable profits.

This is illustrated by the following is an extract from the 2005 Molins plc annual report which shows the volatile effect of impairment charges on maintainable profits:

Consolidated statement of comprehensive income for the year ended 31 December 2005

	<i>Before goodwill impairment and reorganization costs</i>	<i>Goodwill impairment</i>	<i>Reorganisation costs</i>	<i>Total</i>
	M	m	m	M
Revenue	121.4	—	—	121.4
Cost of sales	<u>(85.8)</u>	—	(1.2)	<u>(87.0)</u>
Gross profit	35.6	—	(1.2)	34.4
Other operating income	0.3	—	—	0.3
Distribution expenses	(9.8)	—	(0.2)	(10.0)
Administrative expenses	(18.7)	—	(0.3)	(19.0)
Other operating expenses	<u>(1.2)</u>	(6.7)	(0.5)	<u>(8.4)</u>
Operating profit/(loss)	<u>6.2</u>	<u>(6.7)</u>	<u>(2.2)</u>	<u>(2.7)</u>

17.10 Critical comment on the various methods that have been used to account for goodwill

Let us consider briefly the alternative accounting treatments.

(a) Reporting goodwill unchanged at cost

It is (probably) wrong to keep goodwill unchanged in the statement of financial position, as its value will decline with time. Its value may be *maintained* by further expenditure e.g. continued advertising, but this expenditure is essentially creating ‘internally generated goodwill’ which is not allowed to be capitalised. Sales of most manufactured products often decline during their life and their selling price falls. Eventually, the products are replaced by a technically superior product. An example is computer microprocessors, which initially command a high price, and high sales. The selling price and sales quantities decline as faster microprocessors are produced. Much of the goodwill of businesses is represented by the products they sell. Hence, it is wrong to not amortise the goodwill.

(b) Writing off the cost of the goodwill directly to reserves in the year of acquisition

A buyer pays for goodwill on the basis that future profits will be improved. It is wrong therefore to write it off in the year of acquisition against previous years in the reserves. The loss in value of the goodwill does not occur at the time of acquisition but occurs over a longer period. The goodwill is losing value over its life, and this loss in value should be charged to the statement of comprehensive income each year. Making the charge direct to reserves stops this charge from appearing in the future income statements.

(c) Amortising the goodwill over its expected useful life

Amortising goodwill over its life could achieve a matching under the accrual concept with a charge in the statement of comprehensive income. However, there are problems (i) in determining the life of the goodwill and (ii) in choosing an appropriate method for amortising.

(i) *What is the life of the goodwill?*

Companies wishing to minimise the amortisation charge could make a high estimate of the economic life of the goodwill and auditors had to be vigilant in checking the company’s justification. The range of lives can vary widely. For example, goodwill paid to acquire a business in the fashion industry could be quite short compared to that paid to acquire an established business with a loyal customer base.

(ii) *The method for amortising*

Straight-line amortisation is the simplest method. However, as the benefits are likely to be greater in earlier years than later ones, amortisation could use ‘actual sales’/‘expected total sales’ or the reducing balance method.

It could be argued that amortising goodwill is equivalent to depreciating tangible fixed assets as prescribed by IAS 16 *Property, Plant and Equipment* and that the amortisation approach appears to be the best way of treating goodwill in the statement of financial position and statement of comprehensive income. This is effectively following a ‘statement of comprehensive income’ approach to ‘expense’ (e.g. depreciation) with the expense charged over the life of the asset or in relation to the profits obtained from the acquisition.

There are difficulties but these should not prevent us from using this method. After all, accountants have to make many judgements when valuing items in the statement of financial

position, such as assessing the life of Property, Plant and Equipment, the value of inventory and bad debt provisions.

(d) An annual impairment check

IFRS 3 *Business Combinations* has introduced a new treatment for purchased goodwill when it arises from a business combination (i.e. the purchase of a company which becomes a subsidiary). It assumes that goodwill has an indefinite economic life which means that it is not possible to make a realistic estimate of its economic life and a charge should only be made to the statement of comprehensive income when it becomes impaired.

This is called a ‘statement of financial position approach’ to accounting, as the charge is only made when the value (in the statement of financial position) falls below its original cost.

The IFRS 3 treatment is consistent with the Framework,¹⁶ which says: ‘Expenses are recognised in the statement of comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.’

Criticism of the statement of financial position approach

However, there has been much criticism of the ‘statement of financial position approach’ of the Framework.

For example, if a company purchased specialised plant which had a resale value of 5% of its cost, then it could be argued that the depreciation charge should be 95% of its cost immediately after it comes into use. This is not sensible, as the purpose of buying the plant is to produce a product, so the depreciation charge should be over the life of the product.

Alternatively, if the ‘future economic benefit’ approach was used to value the plant, there would be no depreciation until the future economic benefit was less than its original cost. So, initial sales would incur no depreciation charge, but later sales would have an increased charge.

This example shows the weakness of using ‘impairment’ and the ‘statement of financial position approach’ for charging goodwill to the statement of comprehensive income – the charge occurs at the ‘wrong time’. The charge should be made earlier when sales, selling prices and profits are high, not when the product becomes ‘out of date’ and sales and profits are falling.

Why the Impairment charge occurs at the wrong time

Although the IFRS 3 treatment of ‘impairment’ appears to be correct according to the Framework, it could be argued that the impairment approach is not correct, as the charge occurs at the wrong time (i.e. when there is a loss in value, rather than when profits are being made), it is very difficult to estimate the ‘future economic benefit’ of the goodwill and those estimates are likely to be over-optimistic.

In addition, it means that the treatment of goodwill for IFRS 3 transactions is different from the treatment in IAS 38 *Intangible Assets*. This shows the inconsistency of the standards – they should use a single treatment, either IAS 38 amortisation or IFRS 3 impairment.

17.10.1 Why does the IFRS 3 treatment of goodwill differ from the treatment of intangible assets in IAS 38?

The answer is probably related to the convergence of International Accounting Standards to US accounting standards, and pressure from listed companies.

Convergence pressure

In issuing recent International Standards, the IASB has not only aimed to produce ‘world-wide’ standards but also standards which are acceptable to US standard setters. The IASB wanted their standards to be acceptable for listing on the New York Stock Exchange (NYSE), so there was strong pressure on the IASB to make their standards similar to US Standards. The equivalent US standard to IFRS 3 uses impairment of goodwill as the charge against profits (rather than amortisation). Thus, IFRS 3 uses the same method and it prohibits amortisation.

Commercial pressure

A further pressure for impairment rather than amortisation comes from listed companies. Essentially, listed companies want to maximise their reported profit, and amortisation reduces profit. For most of the time, companies can argue that the ‘future economic benefit’ of the goodwill is greater than its original cost (or carrying value if it has been previously impaired), and thus avoid a charge to the statement of comprehensive income. Also, companies could argue that the ‘impairment charge’ is an unexpected event and charge it as an exceptional item.

In the UK, most companies publicise their ‘profit before exceptional items’ by separating out the impairment charge as seen in the Molins extract above.

17.11 Negative goodwill

Negative goodwill arises when the amount paid is less than the fair value of the net assets acquired. IFRS 3 says the acquirer should:

- (a) reassess the identification and measurement of the acquiree’s identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination in case the assets have been undervalued or the liabilities overstated; and
- (b) recognise immediately in the statement of comprehensive income any excess remaining after that reassessment.

The immediate crediting of negative goodwill to the statement of comprehensive income seems difficult to justify when, as in many situations, the reason why the consideration is less than the value of the net identifiable assets is that there are expected to be future losses or redundancy payments. Whilst the redundancy payments could be included in the ‘contingent liabilities’ at the date of acquisition, standard setters are very reluctant to allow a provision to be made for future losses (this has been prohibited in recent accounting standards). This means that the only option is to say the negative goodwill should be credited to the statement of comprehensive income at the date of acquisition. This results in the group profit being inflated when a subsidiary with negative goodwill is acquired.

In some ways, it would be better to credit the negative goodwill to the statement of comprehensive income over the years the losses are expected. However, the ‘provision for future losses’ (i.e. the negative goodwill) does not fit in very well with the Framework’s definition of a liability as being recognised ‘when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably’. It is questionable whether future losses are a ‘present obligation’ and whether they can be ‘measured reliably’, so it is very unlikely that future losses can be included as a liability in the statement of financial position.

17.12 Intangible assets

Standard setters wanted companies to identify any intangible assets that were acquired and not to include them within a global figure of goodwill. This is important because each intangible can then be amortised under IAS 38 over its economic life i.e. there is no assumption that the asset has an indefinite life. Examples of intangible assets that should be recognised and reported in the Statement of financial position are set out in IAS 38.

IAS 38 gives the following examples of classes of intangible assets:¹⁷

- brand names;
- mastheads and publishing titles;
- computer software;
- licences and franchises;
- copyrights, patents and other industrial property rights, services and operating rights;
- recipes, formulae, models, designs and prototypes;
- intangible assets under development;
- goodwill acquired in a business combination (as we have already seen, IFRS 3 applies here);
- non-current intangible assets classified as held for sale.

17.12.1 Recognition criteria

IAS 38 states that an asset is recognised in respect of an intangible item if the asset is:

Identifiable

One of the difficulties that are faced when considering intangible items is their existence. This is what IAS 38 is examining here. The standard states that for an intangible asset to exist (or be identifiable) it must either be separable or arise from contractual or other legal rights, whether or not the asset can be separately disposed of. This means that in theory a large number of intangible items could create assets.

Controlled by the entity

Control is one of the central features of the Framework definition of an asset. If the entity cannot exercise control over the potential future economic benefits inherent in an item then no asset should be recognised. Therefore, IAS 38 does not normally allow an entity to recognise the potential 'asset' that could be said to exist because of the inherent skills in an assembled workforce. There is generally insufficient control over the workforce to allow asset recognition.

Future economic benefits

Again, it is inherent in the Framework definition of an asset that the potential future economic benefits can be identified with reasonable certainty. If the identifiability and control tests are satisfied then IAS 38 allows recognition of an intangible asset if:

- it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

17.12.2 Meaning of ‘cost’

IAS 38 states that this depends on the way in which the asset arose.

Separate acquisition

In such circumstances ‘cost’ has its normal meaning – as long as the other tests are satisfied recognition of an asset is perfectly possible. An example of such an asset would be a payment for a production licence.

Acquired as part of a business combination

In such a case a single payment has been made for the whole business and in order to complete the accounting it is necessary to allocate the cost as far as possible to the identifiable net assets, with the balance being goodwill accounted for under IFRS 3 (see earlier in the chapter). It is here that the concept of ‘identifiability’ can be applied to intangible items such as:

- customer lists;
- order or production backlogs;
- customer relationships (whether contractual or non-contractual);
- domain names.

If items such as the above have a reliable fair value at the date of acquisition then they can be recognised as separate assets in the statement of financial position of the acquiring company or group.

Internally developed

Based on the reliability criterion, IAS 38 states that only development projects (see earlier in the chapter) that satisfy the stringent criteria laid out in paragraph 57 of the standard can be recognised as internally developed intangibles.

17.12.3 Accounting treatment subsequent to initial recognition

IAS 38 states that recognised intangible non-current assets should be recognised at cost less accumulated amortisation. Revaluation is only permitted if there is an active market in the intangible item. This is relatively unusual for intangible items so revaluations are quite rare.

The asset should be amortised over its estimated useful economic life, in a manner that is very similar to the treatment of property, plant and equipment under IAS 16. Where the estimated useful economic life is indefinite, then no amortisation is required but IAS 38 requires that the asset be subject to annual impairment reviews.

17.12.4 Disclosure of intangible assets under IAS 38

IAS 38 requires the disclosure of the following for each type of intangible asset:¹⁸

- Whether useful lives are indefinite or finite. For finite useful lives, the useful lives or amortisation rates are used.
- The amortisation methods used for intangible assets with finite useful lives.
- The gross carrying amount and accumulated amortisation at the beginning and end of the period.
- Increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in equity (IAS 36 *Impairment of Assets*).

Where an intangible asset is assessed as having an indefinite useful life, the carrying value of the asset must be stated¹⁹ along with the reasons for supporting the assessment of an indefinite life. For example:

As stated in the section on R&D, the financial statements must disclose the charge for research and development in the period.²⁰

Approaches to valuation of intangible assets

Approaches vary with the nature of the intangible. For example, the purchase of trade names and trademarks means that an entity is relieved from the need to pay royalties which can be estimated and discounted to arrive at a present value for the intangible.

Customer lists and supplier relationships mean that there is an expected greater volume of business than could be achieved using the current assets. These intangibles could be valued by identifying their impact on future cash flows. Under this approach, first the business unit that benefits from the intangible is identified, then the cash flows of the unit are established. The next stage is to deduct from the unit cash flows an estimate of the cash flows arising from the other unit assets (both tangible and intangible) assuming a reasonable rate of return on those assets. The difference represents the cash flows estimated to arise from the acquired intangible which can be discounted to arrive at a present value for financial reporting purposes.

Illustration of disclosures from SABMiller 2009 Annual Report and the KCOM Group 2009 Annual Report

The SABMiller Accounting policy explains the amortisation and impairment policy for intangibles with finite lives as follows:

Intangible assets

Intangible assets are stated at cost less accumulated amortisation on a straight-line basis (if applicable) and impairment losses . . . Amortisation is included within net operating expenses in the statement of comprehensive income . . . Intangible assets with finite lives are amortised over their estimated useful economic lives, and only tested for impairment where there is a triggering event.

SABMiller also report an adjusted Earnings per share figure which excludes amortisation of intangible assets:

The group presents the measure of adjusted basic earnings per share, which excludes the impact of amortisation of intangible assets (other than software) and other non-recurring items including post-tax exceptional items, in order to present a more useful comparison of underlying performance for the years shown in the consolidated financial statements.

The KCOM Accounting policy on recognising internally generated intangible assets and notes as to economic lives are as follows:

(i) *The accounting policies state:*

Development costs

An internally-generated intangible asset arising from the Group's internal development activities is recognised only if all of the following conditions are met:

- an asset is created that can be identified (such as software and new processes);
- it is probable that the asset created will generate future economic benefits;
- the development cost of the asset can be measured reliably.

Internally-generated intangible assets are amortised on a straight-line basis over their useful lives. Where no internally-generated intangible asset can be recognised, development expenditure is recognised as an expense in the period in which it is incurred. Research costs are expensed to the statement of comprehensive income as and when they are incurred.

(ii) *The notes disclose the estimated useful lives for amortisation:*

Customer relationships	up to 8 years
Technology and brand	up to 10 years
Software	period of contract up to 5 years
Development	1 year

(iii) *Disclosure in the statement of comprehensive income:*

	2008	2007
Group operating profit	17,673	23,577
Analysed as:		
Group EBITDA	65,312	63,146
Depreciation of property, plant and equipment	(24,023)	(24,192)
Amortisation of intangible assets	(23,616)	(15,377)

17.13 Brand accounting

We have discussed goodwill and intangible assets above but brands deserve a separate consideration because of their major significance in some companies. For example, the following information appears in the 2009 Diageo annual report:

	<i>£m</i>	<i>£m</i>
Total equity (i.e. net assets)		<u>3,936</u>
Intangible assets:		
Brands	4,621	
Goodwill	363	
Other intangible assets	1,122	
Computer software	<u>109</u>	
Total intangible assets		<u>6,215</u>

We can see that brands alone are more than 1.17 times greater than total equity. It is interesting to take a look at the global importance of brands within sectors.

17.13.1 The importance of brands to particular sectors

It is interesting to note that certain sectors have high global brand valuations. For example, the Best Global Brands Report 2008²¹ showed beverages (Coca-Cola), computer software (Microsoft), computer services (IBM), computer hardware (Intel), telecoms (Nokia), automotive (Ford), entertainment (Disney), restaurants (McDonald's) and financial services (Citi) as leading global brands.

The Report ranked the top 100 by brand valuation and showed how valuable brands can be, with the top three exceeding \$45,000 million (Coca-Cola \$66,667 million, IBM \$59,031 million and Microsoft \$59,007 million) and even the hundredth exceeding \$3,000 million (Visa \$3,338 million).

This indicates the importance of investors having as much information as possible to assess management's stewardship of brands. If this cannot be reported on the face of the statement of financial position then there is an argument for having an additional statement to assist shareholders including the information that the directors consider when managing brands.

17.14 Justifications for reporting all brands as assets

We now consider some other justifications that have been put forward for the inclusion of brands as a separate asset in the statement of financial position.

17.14.1 Reduce equity depletion

For acquisitive companies it could be attributed to the accounting treatment required for measuring and reporting goodwill. The London Business School carried out research into the 'brands phenomenon' and found that 'a major aim of brand valuation has been to repair or pre-empt equity depletion caused by UK goodwill accounting rules'.²²

17.14.2 Strengthen the statement of financial position

Non-acquisitive companies do not incur costs for acquiring goodwill, so their reserves are not eroded by writing off purchased goodwill. However, these companies may have incurred promotional costs in creating home-grown brands and it would strengthen the statement of financial position if they were permitted to include a valuation of these brands.²³

17.14.3 Effect on equity shareholders' funds

Immediate goodwill write-off resulted in a fall in net tangible assets as disclosed by the statement of financial position, even though the market capitalisation of a company increased. One way to maintain the asset base and avoid such a depletion of companies' reserves is to divide the purchased goodwill into two parts: the amount attributable to brands and the remaining amount attributable to pure goodwill.²⁴ For instance, WPP capitalised two corporate brand names in 1988 and without that capitalisation, the share owners' funds of £187.7 million in the 1998 accounts would have been reduced by £350 million to a negative figure of (£162.3 million). The 2008 Annual Report shows that total equity now exceeds the brand value but would be reduced to a negative figure if goodwill were not included.

17.14.4 Effect on borrowing powers

The borrowing powers of public companies may be expressed in terms of multiples of net assets. In Articles of Association there may be strict rules regarding the multiple that a company must not exceed. In addition, borrowing agreements and Stock Exchange listing agreements are generally dependent on net assets.

17.14.5 Effect on ratios

Immediate goodwill write-off distorted the gearing ratios, but the inclusion of brands as intangible assets minimised this distortion by providing a more realistic value for shareholders' funds.

17.14.6 Effect on management decisions

It is claimed that including brands on the statement of financial position leads to more informed and improved management decision making. The quality of internal decisions is related to the quality of information available to management.²⁵ As brands represent one of the most important assets of a company, management should be aware of the success or failure of each individual brand. Knowledge about the performance of brands ensures that management reacts accordingly to maintain or improve competitive advantage.

Effect on management decisions – where brands are not capitalised

Whether or not a brand is capitalised, management does take its existence into account when making decisions affecting a company's gearing ratios. For example, in 2007 the Hugo Boss management in explaining its thinking about the advisability of making a Special Dividend payment²⁶ recognised that one effect was to reduce the book value of equity and increase the gearing ratio but commented:

The book value of the equity capital of the HUGO BOSS Group will be reduced by the special dividend. However this perception does not take into consideration that the originally created market value 'HUGO BOSS' is not reflected in the book value of the equity capital. This does not therefore mirror the strong economic position of HUGO BOSS fully.

The implication is that the existence of brand value is recognised by the market and leads to a more sustainable market valuation.

There is also evidence²⁷ that companies with valuable brand names are not including these in their statements of financial position and are not, therefore, taking account of the assets for insurance purposes.

The above are the justifications for recognising internally generated brands as assets. However, IAS 38 prohibits²⁸ this by saying: 'Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.'

17.15 Accounting for acquired brands

Acquired brands require to be valued. In 2009, the International Valuation Standards Council issued an Exposure Draft, *Valuation of Intangible Assets for IFRS Reporting Purposes* (see www.ivsc.org) which considers the need to define more clearly terms used within IFRSs such as 'active' and 'inactive' markets.

A decision is then made in respect of each brand as to whether it should be treated in the financial statements as having a definite or indefinite life. The following is an extract from the accounting policies of WPP in their 2007 Annual Report:

Corporate brand names and customer related intangibles acquired as part of acquisitions of business are capitalised separately from goodwill as intangible assets if their value can be measured reliably on initial recognition and it is probable that the expected economic benefits that are attributable to the asset will flow to the Group.

Certain corporate brands of the Group are considered to have an indefinite economic life because of the institutional nature of the corporate brand names, their proven ability to maintain market leadership and profitable operations over long periods of time and the Group's commitment to develop and enhance their value. The carrying value of

these intangible assets is reviewed at least annually for impairment and adjusted to the recoverable amount if required.

Amortisation is provided at rates calculated to write off the cost less residual value of each asset on a straight-line basis over its estimated life as follows:

Brand names – 10–20 years

Customer related intangibles – 3–10 years

17.15.1 How effective have IFRS 3 and IAS 38 been?

There is still a temptation for companies to treat the excess paid on acquiring a subsidiary as goodwill. If it is treated as goodwill, then there is no requirement to make an annual amortisation charge. If any part of the excess is attributed to an intangible, then this has to be amortised. For example, in the UK the FRRP required Brewin Dolphin Holdings (PLC) to implement a change of accounting policy in the forthcoming financial statements of the company for the period ended 27 September 2009. The company agreed that intangible assets representing client relationships would now be recognised separately from goodwill.

The Panel's principal concern related to the company's practice of not separately recognising customer related intangible assets in the purchase of investment management businesses. IFRS 3 (2004) *Business Combinations* requires an acquirer to recognise intangible assets separately if they meet the definition of an intangible asset in IAS 38 *Intangible Assets* and their fair value can be measured reliably.

This is a clear indication that the FRRP will be policing the allocation of any excess on acquisitions to ensure that there is appropriate effort to attribute to intangible asset categories if that is the economic reality.

However, even so, the information is limited in that only acquired brands can be reported on the statement of financial position, which gives an incomplete picture of an entity's value. Even with acquired brands, their value can only remain the same or be revised downward following an impairment review. This means that there is no record of any added value that might have been achieved by the new owners to allow shareholders to assess the current stewardship.

17.16 Emissions trading

The European Union Emissions Trading Scheme (EU ETS) was created under the Kyoto Protocol. The programme, started in 2005, caps the amount of carbon dioxide (CO₂) emitted by large installations such as power plants and carbon intensive factories and covers about half of the EU's CO₂ emissions. The aim is to progressively reduce these emissions to 5.2% below their 1990 level by 2012.

The government issues companies with free certificates allowing them to emit a stated amount of CO₂. If a company is not going to emit that quantity of CO₂, it can sell the excess in the market, which companies exceeding the limit can buy. So, these certificates have a value. The 'selling company' (Company A) will sell the entitlement if it either has an excess (in certificates) or the value of the certificate is more than the company's cost of reducing its CO₂ emissions. Similarly, the 'buying company' (Company B) will buy the certificates if it is exceeding its CO₂ emissions limit, or the net revenue resulting from the extra CO₂ emissions is more than the cost of buying the certificates.

The questions are:

- How should these certificates be valued in companies' financial statements? and
- Where should they be included in the statement of financial position?

The three possible situations are:

- 1 If the company receives the certificates free from the government, their value in the financial statements should be zero. It would be unreasonable to put a value on them in the company's financial statement (e.g. number of tonnes of CO₂ × CO₂ emissions value per tonne). This would be 'boosting the statement of financial position'.
- 2 If the company is trading in the certificates, they are financial instruments under IAS 39 *Financial Instruments: Recognition and Measurement*. They can be valued at cost, with impairment if their value becomes less than cost. However, it is probably more appropriate to treat them as 'fair value through the profit or loss', value them at market value, and include profits or losses in the statement of comprehensive income.
- 3 If a company buys the certificates to use in its business, they could be accounted for like inventory and valued at the lower of original cost and net realisable value. When the CO₂ emission takes place, their cost will be included in cost of sales.

Answering the question of 'Where should they be included in the statement of financial position?', they could be included:

- as an intangible asset subject to the conditions studied in this chapter;
- as a financial instrument;
- as a prepayment;
- as inventory.

Considering items (1) to (3) above in turn:

- 1 if the certificates have no value, they do not appear in the statement of financial position;
- 2 if they are classified as a financial instrument they will be included in current assets if their life is less than one year;
- 3 this is a problem which will be considered below.

CO₂ emissions certificates have many characteristics of inventory, and the most appropriate accounting treatment is to treat them like inventory. Normally, they will be valued at cost, and they will be charged as cost of sales when the CO₂ emissions take place. Net realisable value (NRV) will apply when the process which produces the CO₂ makes a loss. NRV will be the value which gives a zero profit from the process, but NRV will not be less than zero (negative). The problem with including them as inventory is that inventory is a physical asset, and these emission certificates are not a physical asset (they are an intangible asset).

The certificates could be a financial instrument and valued either at cost, market value or net realisable value. As they are held for use in a production process (which produces CO₂), market value does not seem appropriate. As the CO₂ is emitted, their value will be reduced and the amount charged to cost of sales. It will be like selling part of a holding of shares, but the 'sale' will be a consumption in a production process. Overall, it does not seem appropriate to include the certificates as a financial instrument, as there are more negative factors than including them as inventory.

The certificates could be included as an intangible asset, like the items considered in this chapter. However, most intangible assets last a number of years, and these certificates will probably be used within a year. The accounting standards prohibit amortisation of certain types of goodwill. This should not apply to emission certificates, as they are being consumed in the production process (i.e. as the CO₂ is being emitted, the units of the emission certificates left diminishes).

It is apparent that emission certificates are a current asset, as their life is probably less than a year, and they are consumed in the production process. They come into the category of

‘receivables’, although they are not an amount owed by a customer. They are more like a prepayment. The company buys the certificates (like buying insurance for the future) and consumes them in the future. Most prepayments relate to payments in advance for a future period (e.g. a year for insurance). Emission certificates are different, as they are consumed in proportion to the amount of CO₂ emitted in the future. However, they are probably more like a prepayment than the other items considered.

This discussion is ‘a view’ based on various arguments. It is not a definitive answer. You could consider these and other arguments and come to a different conclusion. It will be interesting to see proposals and a standard approach from the IASB in the future.

Although the scheme has been in operation for over three years, there is no standard treatment. An example of one company’s accounting policy is seen in the following extract from the 2008 annual report of British Energy (now part of EDF):

Accounting policy

Under the EU Emissions Trading Scheme (EU ETS), granted carbon allowances received in a period are initially recognised at nil value within intangible assets. Purchased carbon allowances are initially recognised at cost within intangible assets. Allowances granted are apportioned over the year in line with actual and forecast emissions for the relevant emissions year.

A liability is recognised when actual emissions are greater than the granted allowances apportioned for the year. The liability is measured at the cost of purchased allowances up to the level of purchased allowances held, and then at the market price of allowances ruling at the statement of financial position date, with movements in the liability recognised in operating profit.

Forward contracts for the purchase or sale of carbon allowances are measured at fair value with gains and losses arising from changes in fair value recognised in the consolidated statement of comprehensive income in the unrealised net gains or losses on derivative financial instruments and commodity contracts line. On delivery of forward contracts, carbon allowances are capitalised in intangible assets at cost, with any permanent reduction to bring the carrying value in line with market prices being presented within fuel costs. Carbon allowances have a sustainable value and can be used in settlement of the Group’s EU ETS obligation at any time within the corresponding EU ETS Phase. As a result, carbon allowances are not amortised.

17.17 Intellectual property

According to the World Intellectual Property Organisation (WIPO), intellectual property refers to creations of the mind: inventions, literary and artistic works and symbols, names, images and designs used in commerce. Intellectual property is divided into two categories, namely:

- **industrial property** which includes inventions (patents), trademarks, industrial designs and geographic indications of source; and
- **copyright** which includes literary and artistic works such as novels, poems, plays, films, musical works, artistic works such as drawings, paintings, photographs and sculptures, and architectural designs. Rights related to copyright include those of performing artistes in their performances, producers of phonograms in their recordings, and those of broadcasters in their radio and television programmes.

WIPO²⁹ is an international organisation dedicated to promoting the use and protection of works of the human spirit. These works – intellectual property – are expanding the bounds

of science and technology and enriching the world of arts. Through its work, WIPO plays an important part in enhancing the quality and enjoyment of life as well as creating real wealth for nations. With headquarters in Geneva, Switzerland, WIPO is one of the sixteen specialised agencies of the United Nations system of organisations. It administers twenty-one international treaties dealing with different aspects of intellectual property protection. The organisation counts 175 nations as member states. Its importance is recognised in the following comment by Peter Drucker (www.wired.com/wired/archive/1.03/druker.html):

Knowledge has become the ‘key resource’ of the world economy. The traditional factors of production – land, labour, capital – are becoming restraints rather than driving forces.

And in the UK, a 1998 White Paper³⁰ placed ‘know-how’ at the heart of competitiveness.

Our competitiveness depends on making the most of our distinctive and valuable assets which competitors find hard to imitate. In a modern economy those distinctive assets are increasingly knowledge, skills and creativity rather than traditional factors.

In looking at the relative importance of asset values in businesses, in the 1980s 70% was attributed to tangible assets and 30% to intangible assets. In the mid-1990s, the situation reversed and 30% was tangible assets and 70% intangible assets. More recently 95% has been attributed to intangible assets and 5% to physical and financial assets.

17.17.1 The legal view

As Gallafent, Eastaway and Dauppe³¹ suggest the principal characteristic of all forms of intellectual property is the so-called ‘incorporeal’ nature of that property. It is an abstraction, intangible and as such difficult to protect. To be eligible for legal protection, the author’s or inventor’s work must have been rendered into some tangible form. The term ‘intellectual property’ denotes the rights over a tangible object of the person whose mental efforts created it. The rapid development in communications initially created a problem for the practical application of copyright law as in the recent example of the *Napster* case.³²

17.17.2 Knowledge management

Another term that is currently in use is knowledge management (KM). It has been described as developing business practices and processes that ensure that a business creates, accesses and embeds the knowledge that it needs. Binney³³ sees different elements of the knowledge management spectrum, including, for example, the management of transactional, analytical, process, innovation/creation-based, developmental and asset knowledge.

The first three of these feature as a routine part of a financial and management accountant’s work. They are primarily directed towards efficiency savings and cost control and have an impact on the potential revenues and expenses in the statement of comprehensive income:

- transactional KM – the knowledge is embedded in the system, e.g. how to enter a routine order;
- analytical KM – large amounts of data are turned into information, e.g. inter-firm comparison reports;
- process KM – the focus is on codification and improvement of processes, e.g. total quality management;
- developmental KM – the focus is on the transfer of explicit knowledge via training or education and experiential assignments aimed at increasing companies’ human capital;

- innovation/creation-based KM – the focus is on providing an environment in which knowledge workers, often from different disciplines, can collaborate to create new knowledge resulting in new products. This can encourage staff retention and reduce the cost of staff turnover and has a strategic value if it results in competitive advantage and increased revenues.

The final element is the one that impacts on the statement of financial position:

- asset KM – the focus is on processes to identify and exploit intellectual property.

As far as financial reporting is concerned, the key requirement is that the intellectual capital should be capable of meeting the criteria established in the *Statement of Principles* for classification as an asset if it is to be reported in the statement of financial position. Satisfying the asset criteria has been the major problem for reporting.

17.17.3 The rise of the new economy

This has been principally driven by information and knowledge. It has been identified by the Organisation for Economic Co-operation and Development (OECD) as explaining the increased prominence of intellectual capital as a business and research topic.³⁴

Through a brief examination of the period since the industrial revolution, the following chain of events is observable.³⁵

- Capital and labour were brought together and the factors of production became localised and accessible.
- Firms pushed to increase volumes of production to meet the demands of growing markets.
- Firms began to build intangibles like brand equity and reputation (goodwill) in order to create a competitive advantage in markets where new entrants limited the profit-making potential of a strategy of mass production.
- Firms invested heavily in information technology to increase the quality of products and improve the speed with which those products could be brought to market.
- Firms realised the value of information and worked at managing information and transforming it into the intellectual capital needed to drive the organisation.

At each state of this corporate evolution fixed assets became less important, in relative terms, compared with intangible assets in determining a company's success. Accounting and financial reporting practices, however, have remained largely unchanged.

17.17.4 The OECD definition

The OECD describes intellectual capital³⁶ as the economic value of two categories of intangible assets of a company:

- organisational ('structural') capital; and
- human capital.

Structural capital refers to things like proprietary software systems, distribution networks and supply chains. Human capital includes human resources within the organisation (i.e. staff resources) and resources external to the organisation (namely, customers and suppliers). The term intellectual capital has often been treated as being synonymous with intangible assets. The definition by the OECD makes a distinction by identifying intellectual capital as a subset of, rather than the same as, the intangible assets base of a business.

Traditionally, accounting reports have been prepared on the basis of historical cost. This does not provide for the identification and measurement of intangibles in organisations – especially knowledge-based organisations. The limitations of the existing financial reporting systems have resulted in a move towards finding new ways to measure and report on a company's intellectual capital.

Guthrie, while arguing³⁷ that accountants must find a way to incorporate accurate measures and values of intellectual capital in formal company reports or they will become irrelevant, suggests that the importance of intellectual capital is specifically emphasised in:

- the revolution in information technology and the information society;
- the rising importance of knowledge and the knowledge-based economy;
- the changing patterns of interpersonal activities and the network society;
- the emergence of innovation and creativity as the principal determinant of competitiveness.

In a world of dotcom companies, virtual corporations and a flourishing service industry, book values correlate poorly with market capitalisation.

Intellectual capital is important because a company's intangible assets are a key contributor to its capacity to secure a sustainable competitive advantage. Interest at an academic and professional level is high with an increasing list of articles (see the *Journal of Intellectual Capital*) and research reports.

17.17.5 Intellectual capital disclosures (ICDs) in the annual report

The problem of valuing for financial reporting purposes has meant that investors need to look outside the annual report for information which tends to be predominately narrative. This is highlighted in an ICAEW Research Report³⁸ which comments:

A wide range of media were used to report ICDs, with the annual report accounting for less than a third of total ICDs across all reporting media. Furthermore, the pattern of ICDs in the annual report did not reflect the pattern of ICDs in other reports, so examination of ICDs in annual reports was not a good proxy for overall ICD practices in the sample studied . . . disclosures are overwhelmingly narrative. Previous studies have tended to indicate that monetary expression of IC elements in corporate reports is a relatively rare practice (see, for example, Beattie *et al.*, 2004). This current study of UK ICR practices reinforces this observation.

The report also referred to the fact that preparers of reports did not see that the annual report was the appropriate place to be providing stakeholders with new information on intellectual capital – the annual report being seen as having a confirmatory role in relation to information that was already in the public domain.

It would seem that companies do not consider that their market value is undervalued by the omission of an asset 'intellectual property' provided they keep investors and analysts up to date with developments. A contrary approach could be taken by companies that see an economic value in valuing and reporting in acquisition situations, e.g. payment to acquire customer lists.

17.18 Review of implementation of IFRS 3

IFRS 3, *Business Combinations*, was designed to give greater transparency to how companies accounted for acquisitions. However, recent research appears to indicate that IFRS 3 is not always being correctly applied by the UK's leading companies.

In the year following the introduction of IFRS 3, around £40 billion were spent by FTSE 100 companies on acquisitions, and over half of this (53%) was allocated to goodwill. This is directly opposed to the spirit of IFRS 3. Intangible assets accounted for only 30% of all acquisitions, with the remaining 17% attributed to tangible assets less liabilities.

A certain amount of goodwill is, of course, inevitable. A premium will generally have to be paid to convince shareholders to sell their investment. While this premium by definition is more than the sum of the company's assets, it can still be identified. And you would hope that it already had been identified prior to the takeover approach or else how would the acquiring company know that it can make a return on its investment, thereby justifying the acquisition?

Prior to an acquisition, companies would generally identify likely benefits. This would generate a range within which the acquiring company must remain for the deal to make commercial sense. This could include a premium for value the buyer can bring. The premium could be justified by economies of sale, or synergies that are possible such as reducing overheads like head office costs.

17.18.1 Reasons for inadequate reporting

Unfortunately, it appears that this is not being done when reporting under IFRS 3 – goodwill is not being broken out and intangibles are not being identified. There are several reasons for this, including:

- 1 **To increase profits through reduced amortisation charges.** As goodwill cannot be amortised and intangible assets with finite lives can be, and amortisation is charged to profits, companies are motivated to bolster goodwill and reduce the intangibles.
- 2 **To minimise impairment charges.** Acquired intangible assets must be tested for impairment annually. Any increase may not be recognised but a fall in value must be reported – implicating management for poor performance. Goodwill also has to be tested for impairment, but the criteria are not so stringent.
- 3 **Lack of specialist skills.** As this is the first time that companies have been required to report the value of acquired intangibles, they may lack the specialist skills and knowledge required. They may also lack the confidence to value them accurately.
- 4 **Failure to see the big picture.** As there are so many regulations to comply with and the rules are so complex, there is a danger that companies get so bogged down in the detail that they fail to reassess overall what the business acquisition was about. They fail to see the wood for the trees.

17.18.2 Examples of inadequate reporting

There are many examples of this inadequate reporting, including:

- 1 **Standard Chartered:** In April 2005, Standard Chartered acquired Korea First Bank for \$3.4 billion. Korea First Bank was clearly a substantial business, with 407 branches, 2100 ATMs and 7 km of signage. And although Standard Chartered admits to the significance of Korea First Bank's brand and customers, they only accounted for 7% of the deal value. Goodwill accounted for over half of the acquisition value and is largely unexplained.
- 2 **WPP:** In March 2005, WPP, one of the world's largest marketing services companies purchased Grey Global Group, for £928 million and allocated no value to its brand. What value was allocated to intangible assets was not broken out – as IFRS 3 stipulates and as WPP has done in the past for acquisitions of similar brands such as JWT, Hill & Knowlton, Ogilvy & Mather and Young and Rubicam Group.

- 3 **Aviva:** In March 2005, Aviva bought the RAC for £1.1 billion. The RAC has 7 million customers and is one of the most trusted brands in the UK. The brand and customer relationships should most likely have accounted for the majority of the acquisition price whereas they were reported as being worth only £260 million and £132 million respectively, 35% of the total cost. Goodwill dominates and is unexplained.
- 4 **Kingfisher:** In June 2005 Kingfisher bought OBI, a chain of 13 DIY superstores in China, for its B&Q brand for £144 million, placing no value whatsoever on its brand or customer relationships.

17.18.3 Elements within goodwill but still difficult to value separately

Some of the reasons for this inadequate reporting have already been discussed. But how can goodwill be broken out and valued? Assuming the most common intangible assets, such as brands and customer relationships (which the brand often subsumes anyway), have been valued to reflect reality, the remaining intangibles which are dumped into goodwill can still be valued. In fact, the recognition criteria under IFRS 3 are so broad that it is unlikely that much could actually be included in goodwill. And even if there are such assets, IFRS 3 requires full disclosure and reasons why they have not been valued. This was usually not seen.

There are a number of ways in which goodwill can be identified and valued, some of which are:

- 1 **Workforce in place:** A business's workforce may not be valued under IFRS 3. Its value, therefore, must be recognised within goodwill. Although difficulties exist in valuing people, it is still possible under certain circumstances.
- 2 **Synergies:** Synergies are one of the main motivations for acquisitions – being able to strip out certain costs which will increase the efficiency of the acquired company and the acquiring company as well. Such as:
 - (a) **Cost synergies:** Cost synergies can be rigorously analysed, such as the duplication of head offices or a sales force.
 - (b) **Sales synergies:** Combining two portfolios of products can achieve synergies through cross-selling, or leveraging the combined portfolio. This can be quantified.

Summary

As business has become more complex and industrial processes more sophisticated, the amount paid to develop or acquire an intangible asset has become significant in comparison to the fixed asset base of some companies. IAS 38 allows intangible assets to be recognised if they are identifiable, if the source of future economic benefits can be identified and controlled, and if they have a measurable 'cost'. This means that separately purchased intangibles are recognised at cost, intangibles acquired as part of a business combination are recognised at fair value, and internally developed intangibles are only recognised if they arise out of a development project that satisfies strict criteria.

Any difference between the cost of an acquired business and the fair value of the identifiable net assets is purchased goodwill, which is accounted for according to IFRS 3. Purchased goodwill is not amortised but reviewed annually for impairment.

REVIEW QUESTIONS

- 1 Why do standard setters consider it necessary to distinguish between research and development expenditure, and how does this distinction affect the accounting treatment?
- 2 Discuss the suggestion that the requirement for companies to write off research investment rather than showing it as an asset exposes companies to short-term pressure from acquisitive companies that are damaging to the country's interest.
- 3 Discuss why the market value of a business may increase to reflect the analysts' assessment of future growth but there is no asset in the statement of financial position.
- 4 Here is an extract from the Reckitt Benckiser 2007 Annual Report:

	2007	2006
	£m	£m
Non-current assets		
Intangible assets		
Brands	2,917	2,936
Goodwill and other intangible assets	894	1,485
PPE	<u>479</u>	<u>425</u>
	<u>4,290</u>	<u>4,846</u>
Total equity	<u><u>2,385</u></u>	<u><u>1,866</u></u>

The accounting policy states:

An acquired brand is only recognised on the balance sheet as an intangible asset where it is supported by a registered trademark, is established in the market place, brand earnings are separately identifiable, the brand could be sold separately from the rest of the business and where the brand achieves earnings in excess of those achieved by unbranded products. The value of an acquired brand is determined by allocating the purchase consideration of an acquired business between the underlying fair values of the tangible assets, goodwill and brands acquired.

Brands are not generally amortised, as it is considered that their useful economic lives are not limited... Their carrying values are reviewed annually by the directors to determine whether there has been any permanent impairment in value and any such reductions in their values are taken to the profit and loss account.

Discuss the suggestion that nothing has been achieved by separating the excess of the payment between goodwill and brands if both are treated in the same way, i.e. reported at cost and reviewed for possible impairment.

- 5 The following is an extract from the 2008 Cadbury Report: and Accounts:

i) Brands and other intangibles

Brands and other intangibles that are acquired through acquisition are capitalised on the balance sheet. These brands and other intangibles are valued on acquisition using a discounted cash flow methodology and we make assumptions and estimates regarding future revenue growth, prices, marketing costs and economic factors in valuing a brand. These assumptions reflect management's best estimates but these estimates involve inherent uncertainties, which may not be controlled by management.

Upon acquisition we assess the useful economic life of the brands and intangibles. We do not amortise over 99% of our brands by value. In arriving at the conclusion that a brand has an indefinite life, management considers the fact that we are a brands business and expects to acquire, hold and support brands for an indefinite period. We support our brands through

spending on consumer marketing and through significant investment in promotional support, which is deducted in arriving at Revenue. Many of our brands were established over 50 years ago and continue to provide considerable economic benefits today. We also consider factors such as our ability to continue to protect the legal rights that arise from these brand names indefinitely or the absence of any regulatory, economic or competitive factors that could truncate the life of the brand name. Where we do not consider these criteria to have been met, as was the case with certain brands acquired with Adams, a definite life is assigned and the value is amortised over the life.

Discuss the implication for ratios of maintaining brands at historical cost with the growing emphasis on the use of fair values in financial reporting.

- 6** Discuss the advantages and disadvantages of the proposal that there should be a separate category of asset in the statement of financial position clearly identified as 'research investment – outcome uncertain'.

- 7** The Chloride 2005 Annual Report included the following accounting policy for goodwill:

Goodwill is subject to review at the end of the year of acquisition and at any other time when the directors believe that impairment may have occurred. Any impairment would be charged to the profit and loss account in the period in which the loss occurs.

- (a) Explain the indications that a review for impairment is required.
 (b) Once there are indications of impairment, how is impairment measured?

- 8** How is 'value in use' calculated for an impairment review? What are the areas of subjectivity?
- 9** Critically evaluate the basis of the following assertion: 'I am sceptical that it [the impairment test] will work reliably in practice, given the complexity and subjectivity that lie within the calculation.'³⁹
- 10** IFRS 3 has introduced a new concept into accounting for purchased goodwill – annual impairment testing, rather than amortisation. Consider the effect of a change from amortisation of goodwill (in IAS 22) to impairment testing and no amortisation in IFRS 3, and in particular:

- the effect on the financial statements;
- the effect on financial performance ratios;
- the effect on the annual impairment or amortisation charge and its timing;
- which method gives the fairest charge over time for the value of the goodwill when a business is acquired;
- whether impairment testing with no amortisation complies with the IASC's *Framework for the Preparation and Presentation of Financial Statements*;
- why there has been a change from amortisation to impairment testing – is this pandering to pressure from the US FASB and/or listed companies?

- 11** A research report into the use of IFRS 3 (www.intangiblebusiness.com/Content/2441) concluded:
- However IFRS 3 has not been followed, through undervaluing intangible assets acquired with a corresponding exaggeration of goodwill. Throughout there is a lack of disclosure. So the rationale justifying acquisitions is inadequate and £21 billion has been lost in an accounting black hole called goodwill.

Discuss reasons for the undervaluing of intangibles and exaggeration of goodwill.

- 12** One goodwill impairment indicator is the loss of key personnel.
 Discuss two further possible indicators.

EXERCISES

An extract from the solution is provided on the Companion Website (www.pearsoned.co.uk/elliott-elliott) for exercises marked with an asterisk (*).

Question 1

Environmental Engineering plc is engaged in the development of an environmentally friendly personal transport vehicle. This will run on an electric motor powered by solar cells, supplemented by passenger effort in the form of pedal assistance.

At the end of the current accounting period, the following costs have been attributed to the project:

- (a) A grant of £500,000 to the Polytechnic of the South Coast Faculty of Solar Engineering to encourage research.
- (b) Costs of £1,200,000 expended on the development of the necessary solar cells prior to the decision to incorporate them in a vehicle.
- (c) Costs of £5,000,000 expended on designing the vehicle and its motors, and the planned promotional and advertising campaign for its launch on the market in twelve months' time.

Required:

- (i) Explain, with reasons, which of the above items could be considered for treatment as deferred development expenditure, quoting any relevant International Accounting Standard.
- (ii) Set out the criteria under which any items can be so treated.
- (iii) Advise on the accounting treatment that will be afforded to any such items after the product has been launched.

Question 2

As chief accountant at Italin NV, you have been given the following information by the director of research:

Project Luca

	€000
Costs to date (pure research 25%, applied research 75%)	200
Costs to develop product (to be incurred in the year to 30 September 20X1)	300
Expected future sales per annum for 20X2–20X7	1,000
<i>Fixed assets purchased in 20X1 for the project:</i>	
Cost	2,500
Estimated useful life	7 years
Residual value	400

(These assets will be disposed of at their residual value at the end of their estimated useful lives.)

The board of directors considers that this project is similar to the other projects that the company undertakes, and is confident of a successful outcome. The company has enough finances to complete the development and enough capacity to produce the new product.

Required:

Prepare a report for the board outlining the principles involved in accounting for research and development and showing what accounting entries will be made in the company's accounts for each of the years ending 30 September 20X1–20X7 inclusive.

Indicate what factors need to be taken into account when assessing each research and development project for accounting purposes, and what disclosure is needed for research and development in the company's published accounts.

*** Question 3**

Oxlag plc, a manufacturer of pharmaceutical products, has the following research and development projects on hand at 31 January 20X2:

- (A) A general survey into the long-term effects of its sleeping pill Chalcedon upon human resistance to infections. At the year-end the research is still at a basic stage and no worthwhile results with any particular applications have been obtained.
- (B) A development for Meebach NV in which the company will produce market research data relating to Meebach's range of drugs.
- (C) An enhancement of an existing drug, Euboia, which will enable additional uses to be made of the drug and which will consequently boost sales. This project was completed successfully on 30 April 20X2, with the expectation that all future sales of the enhanced drug would greatly exceed the costs of the new development.
- (D) A scientific enquiry with the aim of identifying new strains of antibiotics for future use. Several possible substances have been identified, but research is not sufficiently advanced to permit patents and copyrights to be obtained at the present time.

The following costs have been brought forward at 1 February 20X1:

	Project	A	B	C	D
		£000			
Specialised laboratory					
Cost		—	—	500	—
Depreciation		—	—	25	—
Specialised equipment					
Cost		—	—	75	50
Depreciation		—	—	15	10
Capitalised development costs		—	—	200	—
Market research costs		—	250	—	—

The following costs were incurred during the year:

	Project	A	B	C	D
		£000			
Research costs		25	—	265	78
Market research costs		—	75	—	—
Specialised equipment cost		50	—	—	50

Depreciation on specialised laboratories and special equipment is provided by the straight-line method and the assets have an estimated useful life of 25 and five years respectively. A full year's depreciation is provided on assets purchased during the year.

Required:

- (i) Write up the research and development, fixed asset and market research accounts to reflect the above transactions in the year ended 31 January 20X2.
- (ii) Calculate the amount to be charged as research costs in the statement of comprehensive income of Oxlag plc for the year ended 31 January 20X2.
- (iii) State on what basis the company should amortise any capitalised development costs and what disclosures the company should make in respect of amounts written off in the year to 31 January 20X3.
- (iv) Calculate the amounts to be disclosed in the statement of financial position in respect of fixed assets, deferred development costs and work-in-progress.
- (v) State what disclosures you would make in the accounts for the year ended 31 January 20X2 in respect of the new improved drug developed under project C, assuming sales begin on 1 May 20X2, and show strong growth to the date of signing the accounts, 14 July 20X2, with the expectation that the new drug will provide 25% of the company's pre-tax profits in the year to 31 January 20X3.

Question 4

International Accounting Standards IFRS 3 and IAS 38 address the accounting for goodwill and intangible assets.

Required:

- (a) Describe the requirements of IFRS 3 regarding the initial recognition and measurement of goodwill and intangible assets.
- (b) Explain the proposed approach set out by IFRS 3 for the treatment of positive goodwill in subsequent years.
- (c) Territory plc acquired 80% of the ordinary share capital of Yukon Ltd on 31 May 20X6. The statement of financial position of Yukon Ltd at 31 May 20X6 was:

Yukon Ltd – Statement of financial position at 31 May 20X6

Non-current assets	£000
Intangible assets	6,020
Tangible assets	<u>38,300</u>
	<u>44,320</u>
Current assets	
Inventory	21,600
Receivables	23,200
Cash	<u>8,800</u>
	<u>53,600</u>
Current liabilities	<u>24,000</u>
Net current assets	<u>29,600</u>
Total assets less current liabilities	<u>73,920</u>
Non-current liabilities	12,100
Provision for liabilities and charges	<u>3,586</u>
	<u>58,234</u>
Capital reserves	
Called-up share capital (ordinary shares of £1)	10,000
Share premium account	5,570
Retained earnings	<u>42,664</u>
	<u>58,234</u>

Additional information relating to the above statement of financial position

- (i) The intangible assets of Yukon Ltd were brand names currently utilised by the company. The directors felt that they were worth £7 million but there was no readily ascertainable market value at the statement of financial position date, nor any information to verify the directors' estimated value.
- (ii) The provisional market value of the land and buildings was £20 million at 31 May 20X6. This valuation had again been determined by the directors. A valuers' report received on 30 November 20X6 stated the market value of land and buildings to be £23 million as at 31 May 20X6. The depreciated replacement cost of the remainder of the tangible fixed assets was £18 million at 31 May 20X6.
- (iii) The replacement cost of inventories was estimated at £25 million and its net realisable value was deemed to be £20 million. Trade receivables and trade payables due within one year are stated at the amounts expected to be received and paid.
- (iv) The non-current liability was a long-term loan with a bank. The initial loan on 1 June 20X5 was £11 million at a fixed interest rate of 10% per annum. The total amount of the interest is to be paid at the end of the loan period on 31 May 20X9. The current bank lending rate is 7% per annum.
- (v) The provision for liabilities and charges relates to costs of reorganisation of Yukon Ltd. This provision had been set up by the directors of Yukon Ltd prior to the offer by Territory plc and the reorganisation would have taken place even if Territory plc had not purchased the shares of Yukon Ltd. Additionally Territory plc wishes to set up a provision for future losses of £10 million which it feels will be incurred by rationalising the group.
- (vi) The offer made to all of the shareholders of Yukon Ltd was 2.5 £1 ordinary shares of Territory plc at the market price of £2.25 per share plus £1 cash, per Yukon Ltd ordinary share.
- (vii) The directors of Yukon Ltd informed Territory plc that as at 31 May 20X7, the brand names were worthless as the products to which they related had recently been withdrawn from sale because they were deemed to be a health hazard.
- (viii) In view of the adverse events since acquisition, the directors of Territory plc have impairment-tested the goodwill relating to Yukon SA, and they estimate its current value is £1 million.

Required:

Calculate the charge for impairment of goodwill in the Group Statement of Comprehensive Income of Territory plc for the accounting period ending on 31 May 20X7.

Question 5

The brands debate

Under IAS 22, the depletion of equity reserves caused by the accounting treatment for purchased goodwill resulted in some companies capitalising brands on their statements of financial position. This practice was started by Rank Hovis McDougall (RHM) – a company which has since been taken over. Martin Moorhouse, the group chief accountant at RHM, claimed that putting brands on the statement of financial position forced a company to look to their value as well as to profits. It served as a reminder to management of the value of the assets for which they were responsible and that at the end of the day those companies which were prepared to recognise brands on the statement of financial position could be better and stronger for it.⁴⁰

There were many opponents to the capitalisation of brands. A London Business School research study found that brand accounting involves too many risks and uncertainties and too much subjective judgement.

In short, the conclusion was that 'the present flexible position, far from being neutral, is potentially corrosive to the whole basis of financial reporting and that to allow brands – whether acquired or home-grown – to continue to be included in the statement of financial position would be highly unwise'.⁴¹

Required:

Consider the arguments for and against brand accounting. In particular, consider the issues of brand valuation; the separability of brands; purchased vs home-grown brands; and the maintenance/substitution argument.

* Question 6

Brands plc is preparing its accounts for the year ended 31 October 20X8 and the following information is available relating to various intangible assets acquired on the acquisition of Countrywide plc.

- (a) A milk quota of 2,000,000 litres at 30p per litre. There is an active market trading in milk and other quotas.
- (b) A government licence to experiment with the use of hormones to increase the cream content of milk had been granted to Countrywide shortly before the acquisition by Brands plc. No fee had been required. This is the first licence to be granted by the government and was one of the reasons that Brands acquired Countrywide. The licence is not transferable but the directors estimate that it has a value to the company based on discounted cash flows for a five-year period of £1 million.
- (c) A full cream yoghurt sold under the brand name 'Naughty but Nice' was valued by the directors at £2 million. Further enquiry established that a similar brand name had been recently sold for £1.5 million.

Required:

Explain how each of the above items would be treated in the consolidated financial statements using IAS 38.

Question 7

IAS 38 – *Intangible Assets* – was primarily issued in order to identify the criteria that need to be present before expenditure on intangible items can be recognised as an asset. The standard also prescribes the subsequent accounting treatment of intangible assets that satisfy the recognition criteria and are recognised in the statement of financial position.

Required:

- (a) Explain the criteria that need to be satisfied before expenditure on intangible items can be recognised in the statement of financial position as intangible assets.
- (b) Explain how the criteria outlined in (a) are applied to the recognition of separately purchased intangible assets, intangible assets acquired in a business combination, and internally generated intangible assets. You should give an example of each category discussed.
- (c) Explain the subsequent accounting treatment of intangible assets that satisfy the recognition criteria of IAS 38.

Iota prepares financial statements to 30 September each year. During the year ended 30 September 20X6 Iota (which has a number of subsidiaries) engaged in the following transactions:

- I On 1 April 20X6 Iota purchased all the equity capital of Kappa and Kappa became a subsidiary from that date. Kappa sells a branded product that has a well-known name and the directors of Iota have obtained evidence that the fair value of this name is \$20 million and that it has a useful economic life that is expected to be indefinite. The value of the brand name is not included in

the statement of financial position of Kappa as the directors of Kappa do not consider that it satisfies the recognition criteria of IAS 38 for internally developed intangible assets. However, the directors of Kappa have taken legal steps to ensure that no other entities can use the brand name.

- 2 On 1 October 20X4 Iota began a project that sought to develop a more efficient method of organising its production. Costs of \$10 million were incurred in the year to 30 September 20X5 and debited to the statement of comprehensive income in that year. In the current year the results of the project were extremely encouraging and on 1 April 20X6 the directors of Iota were able to demonstrate that the project would generate substantial economic benefits for the group from 31 March 20X7 onwards as its technical feasibility and commercial viability were clearly evident. Throughout the year to 30 September 20X6 Iota spent \$500,000 per month on the project.

Required:

- (d) Explain how both of the above transactions should be recognised in the financial statements of Iota for the year ending 30 September 20X6. You should quantify the amounts recognised and make reference to relevant provisions of IAS 38 wherever possible.

Question 8

- (a) Explain what is meant by 'component depreciation' and its status under international accounting standards.
- (b) Trin, a limited liability company, owns its business premises. It has just installed extensive specialised machinery and fittings in the premises. The estimated remaining useful life is 10 years for the building and 6 years for the machinery and fittings. Trin knows that decommissioning the machinery and fittings in 6 years' time will cost around \$910,000 at current prices.

Required:

Explain, with reasons, how Trin should account for the costs of decommissioning its machinery and fittings.

- (c) Cozz, a limited liability company, has an asset, purchased on 1 November 2002, which was reported in its balance sheet as at 1 November 2006 as follows:

	\$
Cost	240,000
Accumulated depreciation	<u>118,000</u>
	<u>122,000</u>

The accumulated depreciation figure is made up as follows:

	\$
Four years' depreciation based on the asset's estimated life of 12 years	80,000
Impairment recognised during the year ended 31 October 2005	20,000
Impairment recognised during the year ended 31 October 2006	<u>18,000</u>
	<u>118,000</u>

As at 31 October 2007 there was no change to the estimate of this asset's economic life or residual value. The asset's recoverable amount was estimated to be \$125,000 as at 31 October 2007. Cozz reports this class of assets at historical cost.

Required:

What charge will Cozz make in its income statement for the year ended 31 October 2007 for this asset and how will the asset be reported in the balance sheet as at 31 October 2007?

- (d) The following is the summarised balance sheet of Grimsel, a limited liability company, as at 31 October 2007.

ASSETS		\$000
<i>Non-current assets:</i>		
Property, plant and equipment		7,540
<i>Current assets:</i>		
Inventory	2,230	
Receivables	4,120	
Cash	<u>430</u>	
		<u>6,780</u>
		<u>14,320</u>
LIABILITIES AND EQUITY		
Current liabilities		3,775
Non-current liabilities		12,500
<i>Equity:</i>		
Issued share capital	5,000	
Accumulated losses	<u>6,955</u>	
		<u>(1,955)</u>
		<u>14,320</u>

Grimsel has been a very successful company in its time. However, a series of losses due to a declining share in the market and demands from its bankers for repayment of significant bank debt included in current and non-current liabilities have left its shareholders keen to sell.

Brenner, another limited liability company, operates in the same line of business as Grimsel. Brenner has been very successful and sees an opportunity to acquire Grimsel at a bargain price.

Brenner has successfully concluded negotiations with Grimsel and has agreed a price of \$2,000,000 for all the issued share capital of Grimsel.

The following additional information is available:

- (i) The value of all the assets and liabilities identified in Grimsel's balance sheet were agreed as fair values for the purposes of the purchase with the exception of the following assets:
- | | |
|-------------------------------|-------|
| Fair values | \$000 |
| Property, plant and equipment | 8,000 |
| Inventory | 2,000 |
| Receivables | 3,710 |
- (ii) Grimsel has a deferred income tax asset of \$2,200,000. This is not shown in Grimsel's balance sheet because it was unlikely that Grimsel would be able to recover this amount because of its continuing losses. Brenner is trading profitably in the same type of business and will be able to realise this benefit.
- (iii) Grimsel has significant patents which were internally developed. These patents are still useful and an independent valuer has given them a fair value of \$1,000,000.
- (iv) Brenner will also take over Grimsel's customer list. This is a sensitive area. While the customer list was not of much value to Grimsel, the directors of Brenner feel that it could be of significant value but wish to continue keeping it off the balance sheet. An independent valuer has estimated the fair value of the customer list to Brenner as \$1,500,000.

Required:

Applying the rules in IFRS 3 calculate the amount of goodwill arising on the acquisition of Grimsel by Brenner.

(e) Summarise the guidance in IFRS 3 when goodwill turns out to be a negative.

(The Association of International Accountants)

Question 9

Ross Neale is the divisional accountant for the Research and Development division of Critical Pharmaceuticals PLC. He is discussing the third-quarter results with Tina Snedden who is the manager of the division. The conversation focuses on the fact that whilst they have already fully committed the development capital expenditure budget for the year, the annual expense budget for research is well under spent because of the staff shortages which occurred in the last quarter. Tina mentions that she is under pressure to meet or exceed her expense budgets this year as the industry is renegotiating prescription costs this year and don't want to be seen to be too profitable.

Ross suggests that there are several strategies they could employ namely:

- (a) Several of the subcontractors have us as their largest customer and so we could ask them to describe the services in the fourth quarter, which are essentially development cost, as research costs.
- (b) We could ask them to charge us in advance for research work that will be required in quarter one next year without mentioning that it is an advance in documentation. That would be good for them as it would improve their cash flow and it would guarantee that they would get the work next year.
- (c) We could ask some of the subcontractors on development projects to charge us in first quarter next year and we could hold out to them that we would give them some better priced projects in next year to compensate them for the interest incurred as a result of the delayed payment.

Required:

Discuss the advantages and disadvantages of adopting these strategies.

Question 10

James Bright has just taken up the position of managing director following the unsatisfactory achievements of the previous incumbent. James arrives as the accounts for the previous year are being finalised. James wants the previous performance to look poor so that whatever he achieves will look good in comparison. He knows that if he can write off more expenses in the previous year, he will have lower expenses in his first year and possibly a lower asset base. He gives directions to the accountants to write off as many bad debts as possible and to make sure accruals can be as high as they can get past the auditors. Further, he wants all brand name assets reviewed using assumptions that the sales levels achieved during the economic downturn are only going to improve slightly over the foreseeable future. Also he mentions that the cost of capital has risen over the period of the financial crisis so the projected benefits are to be discounted at a higher rate. Preferably at a much higher rate than that used in the previous reviews!

Required:

Discuss the accountant's professional responsibility and any ethical questions arising in this case.

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