

How to “create” an intangible asset in your financial statement

(Relevant to AAT Examination Paper 7 – Financial Accounting)

Annie Mok Yuet-ngo, City University of Hong Kong

HKAS 38 “Intangible Assets” sets out conditions that should have been satisfied in order for an intangible asset in the non-current asset section under a statement of financial position to be recognized. The accounting standard stipulates different sets of conditions to be fulfilled for an entity to recognize an externally-purchased intangible asset and an internally-generated intangible asset.

This article focuses on the various additional conditions to be fulfilled if an entity wants to recognize an internally-generated intangible asset. This article is divided into two parts. The first part discusses the six additional conditions for recognition of an internally-generated intangible asset other than goodwill. The second part focuses on internally-generated goodwill.

Internally-generated intangible asset other than goodwill

HKAS 38 “Intangible Assets” requires the entity to divide the process of the internal generation of an intangible asset into two phases, namely the research phase and development phase. If the entity cannot distinguish the research phase from the development phase, the accounting standard requires that the entity should treat the expenditure on the whole internal project as if it were incurred in the research phase only.

Research phase:

HKAS 38 provides four examples of research activities. They are:

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

HKAS 38 does not allow an entity to recognize any expenditure in the research phase as an intangible asset presented under the non-current asset section of its statement of financial position. Instead, the related expenditure incurred in the research phase should be recorded as an expense to be presented under an income statement to offset the current period’s income to arrive at the net profit or loss.

Development phase:

HKAS 38 provides four examples of development activities. They are:

- the design, construction and testing of pre-production or pre-use prototypes and models;
- the design of tools, jigs, moulds and dies involving new technology;
- the design, construction and operation of a pilot plant that is not of a scale

- economically feasible for commercial production; and
- the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

If expenditure is not recognized as relating to an intangible asset under the research phase, this does not automatically allow the entity to recognize the expenditure as an intangible asset under the development phase. Instead, in the development phase, the entity may recognize an intangible asset only if it can demonstrate all of the following six criteria:

- The entity should demonstrate that it is technically feasible to complete the intangible asset so that it will be available for use or sale.
- The entity should demonstrate that it has an intention to complete the intangible asset and use or sell it.
- The entity should demonstrate that it has the ability to use or sell the intangible asset.
- The entity should demonstrate how the intangible asset will be able to generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- The entity should demonstrate that adequate technical, financial and other resources are available to complete the development and to use or sell the intangible asset.
- The entity should demonstrate that it has the ability to measure reliably the expenditure attributable to the intangible asset during its development.

Internally generated goodwill

HKAS 38 does not allow an entity to recognize internally generated goodwill as an asset.

The reason why internally generated goodwill is not recognized as an asset is because it is not separable and it does not arise from contractual or other legal rights and, hence, is not an identifiable asset controlled by the entity that can be measured reliably at cost.

Conclusion

In summary, in accordance with HKAS 38 “Intangible Assets”, an entity should only recognize an internally generated intangible asset other than goodwill when all the six conditions stipulated above are fulfilled. If any one of them is not satisfied, the entity should not recognize the related expenditure as an intangible asset; instead, the expenditure should be expensed in the income statement. HKAS 38 “Intangible Assets” also prohibits an entity from recognizing internally-generated goodwill as an asset.