

# CHAPTER 1

# Recognizing Intangible Assets

## A. Introduction and Background

For financial reporting purposes, “intangible assets” consist of assets (not including financial assets) that lack physical substance.<sup>1</sup> Intangible assets are getting more and more important to companies and their owners as the economies of many developed countries have changed from industrial to knowledge-based. The manufacturing/industrial value chain is no longer the primary driver of value creation; it is innovation and constantly seeking new ways of meeting market demands. Companies seek to differentiate themselves through the creation or acquisition of intangible assets to create competitive advantages. With the increased importance of their intangible assets, the need for relevant and

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<sup>1</sup>ASC Term “Intangible Assets.”

reliable financial information for their existence and valuation is increasing.

The necessity of valuing intangible assets as accurately as possible is tied to the growing significance of such assets.<sup>2</sup> The FASB put the situation more mildly: “At the inception of [FAS 142], the [FASB] observed that intangible assets make up an increasing proportion of the assets of many (if not most) entities.”<sup>3</sup> With such a large percentage of total assets classified as intangible assets, it no longer takes an extremely large error to affect financial statements. Even small valuation errors, if made repeatedly, can mushroom into very large valuation errors on the financial statements.<sup>4</sup>

### Comment

The relevance of intangible assets has been well documented in the academic research literature. Firms can gain competitive advantage and achieve superior performance by holding, acquiring, and effectively using intangible assets. Intangible

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<sup>2</sup>Because self-generated intangible assets generally are not recognized in financial statements, they are not part of book value even though they are part of market value. In 1975, it is estimated that the book values of the S&P 500 companies accounted for 83 percent of their market values. This estimate decreased to 68 percent in 1985, 32 percent in 1995, and 20 percent in 2005. In 2010 the estimate remained the same as 2005 with approximately 80 percent of the market value of the S&P 500 companies not accounted for on their balance sheets. From a diagram titled, “The Data Financial Management,” July/August 2013, p. 21, Diagram.

<sup>3</sup>FAS 142, ¶ B28 (background material not codified).

<sup>4</sup>A study of the impact of intangible assets on financial statements by the AAA Financial Accounting Standards Committee concluded the following: “Perhaps the best conclusion about research in this area is that the results are mixed, with no clear evidence of a decline in the value relevance of financial statement information over time, even for high-technology firms. Thus, there is not clear evidence supporting claims that traditional financial statements have become less relevant to investors over time.” Of course, the failure to find supporting evidence might be a research failure. This type of research is very difficult. Linda Vincent, “Implications of Accounting Research for the FASB’s Initiatives on Disclosure of Information about Intangible Assets,” *Accounting Horizons*, 2003, Vol. 17, p. 175.

assets are valuable due in part because they tend to be more rare, nonsubstitutable, and hard to imitate. Studies have found a positive relationship between such intangible assets and firm performance measures. One study found a positive relationship between intellectual capital and firm performance measures.<sup>5</sup> Another study examined several intangible assets (R&D, advertising, training, software acquisitions, and product quality) and found that these assets are positively associated with a firm's ability to generate future operating cash flows.<sup>6</sup> In another study, a researcher found that firms capitalize intangible assets more aggressively when they are nearing failure. In addition, he finds that managers' propensity to capitalize intangible assets has a strong statistical association with earnings management. These findings suggest that capitalizing earnings aggressively is associated with distressed firms in which managers also likely may have incentives to aggressively manage earnings.<sup>7</sup>

Increasingly, intangible assets come from unique entity organizational designs and business processes that companies use to outperform competitors. Tangible assets that in the past have allowed entities to gain a productive edge over competitors no longer allow the same advantage. Unless equipment is very expensive, the productive equipment that might have allowed a competitive advantage is now within the financial range of both large and small firms. The barriers to entry in many fields have fallen. Intangible assets can now form the competitive edge that tangible assets once formed. Examples include:

- a. Dell allows built-to-order computers (customers design their own computers).

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<sup>5</sup>Komnencic, B. Tomic, and R. Tomic, "Intangible Assets and Business Performance," *Journal of American Business Review*, Summer 2013, pp. 165–172.

<sup>6</sup>S. Boujelben and F. Hassouna, "The Effects of Intangible Investments on Future OCF," *Journal of Intellectual Capital*, 2012 (4), pp. 480–494.

<sup>7</sup>S. Jones, "Does the Capitalization of Intangible Assets Increase the Predictability of Corporate Failure?," *Accounting Horizons*, March 2011, Vol. 25, Issue 1, pp. 41–70.

- b. Wal-Mart has a supply chain that essentially shifts its inventory management to its suppliers. (Wal-Mart's smaller competitors cannot duplicate this supply chain.)
- c. Benetton, an Italian apparel manufacturer, has a unique information system relaying real-time information about product colors between stores and manufacturing facilities.
- d. Citibank has an online (internet-based) banking system that allows it to seek customers all over the world. Moreover, the synergy between different parts of the banking system, such as mortgages and credit cards, is high.<sup>8</sup>

These are but a few of the thousands of intangible assets that businesses use to gain a competitive edge on their competitors.

ASC 805-20-55 lists a number of intangible assets. Exhibit 1.1 presents these intangible assets.<sup>9</sup>

#### EXHIBIT 1.1 Intangible Assets

Trademarks, trade names	Service marks, collective marks, certification marks
Trade dress (unique color, shapes, or package design)	Newspaper mastheads
Internet domain names	Not-to-compete agreements
Customer lists	Order or production backlog
Customer contracts and related customer relationships	Noncontractual customer relationships
Plays, operas, ballets	Musical works such as compositions, song lyrics, or advertising jingles
Pictures, photographs	Video and audiovisual material
Licensing, royalty, standstill agreements	Advertising, construction, management, service, or supply contracts
Lease agreements	Construction permits
Franchise agreements	Operating or broadcast rights
Use rights for drilling, water, etc.	Servicing contracts
Employment contracts	Patented technology
Computer software and mask works	Unpatented technology
Databases, including title plants	Trade secrets

<sup>8</sup>All four examples are further elaborated on in Baruch Lev, *Encyclopedia of Social Measurement* 300 (2005).

<sup>9</sup>A full discussion of these intangible assets, divided into five categories, is in ASC 805-20-55-11 through ASC 805-20-55-45.

The list of intangible assets in IFRS 3 is under “Examples of items acquired in a business combination that meet the definition of an intangible asset.”<sup>10</sup> The list is almost identical to the list in ASC 805-20-55.

The FASB did not mean this list to be exhaustive.<sup>11</sup>

## B. Recognizing Intangible Assets under IFRS

Intangible assets that appear on an entity’s balance sheet can be self-created, purchased in a business acquisition, or purchased in a transaction that does not constitute a business combination (known as an asset acquisition). Each of these categories contains its own rules in a separate subtopic of the FASB Codification, and each is discussed in the following subsections of this chapter. In contrast, all of the IFRS rules on intangible assets in these categories are contained in IAS 38.<sup>12</sup> IAS 38 has a general definition of an intangible asset that applies to all of the categories and then specific rules for each category. This subsection explains the general definition and the specific rules are discussed in the appropriate subsections below.

### Comment

IAS 38 applies to all intangible assets except the following: (1) financial assets, (2) mineral rights and exploration and development costs incurred by mining and oil and gas companies, and (3) intangible assets covered by another IAS, such as intangibles held for sale, deferred tax assets, lease assets, assets arising from employee benefits, and goodwill.

For an item to be recognized as an intangible asset under IAS 38, it must meet the standard’s definition of an intangible asset and the standard’s recognition criteria.<sup>13</sup>

<sup>10</sup>These examples accompany, but are not part of, IFRS 3.

<sup>11</sup>ASC 805-20-55-11.

<sup>12</sup>See generally IAS 38, ¶¶ 2, 3.

<sup>13</sup>IAS 38, ¶ 18.

## 1. Definitional Criteria

The definition of an intangible asset under IAS 38 is not appreciably or conceptually different from U.S. GAAP, but it is presented in a different manner. IAS 38 defines an intangible asset as “an identifiable non-monetary asset without physical substance.” It further defines an asset as a resource that: (1) is controlled by an entity as a result of past events and (2) from which future economic benefits are expected to flow to the entity. Thus, the three critical attributes of the IFRS definition of an intangible asset are as follows: (1) identifiability, (2) control over the asset by the entity, and (3) expected future economic benefits.<sup>14</sup>

### *a. Identifiability*

The definition of an intangible asset requires an asset to be identifiable to distinguish it from goodwill.<sup>15</sup> An asset is identifiable if it meets the following criteria:

- Is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, whether individually or as part of a package), or
- Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.<sup>16</sup>

#### **Comment**

This two-prong test is the same test applied under U.S. GAAP to identify intangible assets that are separate from goodwill when acquired in a business combination, but under IFRS the test applies to all intangible assets, not just those acquired in a business combination.

<sup>14</sup>IAS 38, ¶ 10.

<sup>15</sup>IAS 38, ¶ 11.

<sup>16</sup>IAS 38, ¶ 12.

### *b. Control*

The second attribute under the IFRS definition of an intangible asset is control over the asset's future economic benefits. Specifically, an entity must control the asset for the asset to meet the definition of an intangible asset. Control refers to the power to derive future economic benefits from the asset and to restrict others from access to those benefits. An entity meets the control criterion when there are legal rights attached to the resource in question that are enforceable in a court of law. For example, an entity might be able to protect its technical knowledge in patents and copyrights in court.<sup>17</sup> However, if there are no legal rights attached to the resource, the control criterion may still be met if there are exchange transactions for the same or similar assets. Such exchange transactions provide evidence that an entity is able to control the expected future economic benefits from the asset.<sup>18</sup> A classic example of assets that do not have legal rights attached to them but that often have exchange transactions are customer lists and other customer relationship intangible assets.

### *c. Future Economic Benefits*

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.<sup>19</sup> However, future economic benefits do not apply to pseudo-profit centers.<sup>20</sup> That is, a company cannot create future economic benefits by transferring costs or profits from somewhere else in the company.

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<sup>17</sup>IAS 38, ¶ 13.

<sup>18</sup>IAS 38, ¶ 16. Exchange transactions for the same or similar assets also are evidence that an asset is separable and thus meets the identifiability criterion.

<sup>19</sup>IAS 38, ¶ 17.

<sup>20</sup>Pseudo-profit centers are profit centers created from transfer prices. For further information, see Ralph L. Benke, Jr. and James Don Edwards, "Should You Use Transfer Pricing to Create Pseudo-Profit Centers?," *Mgmt. Acct.*, February 1981, pp. 36–39, 43.

## 2. Recognition Criteria

In addition to meeting the definitional criteria for an intangible asset, to be recognized as a separately identifiable asset in a company's financial statements an intangible asset also must meet the recognition criteria. These criteria are as follows: (1) it is probable that the expected future economic benefits from the asset will flow to the entity, and (2) the cost of the asset can be measured reliably.<sup>21</sup> Applying the probability standard in this instance requires considerable judgment, as management must both: (1) estimate the set of economic conditions that will exist over the useful life of the intangible asset, and (2) assess the degree of certainty attached to the flow of the economic benefits. Not surprisingly, the IASB considers external evidence supporting these judgments to have greater weight than internally generated evidence or assumptions.<sup>22</sup>

## 3. Examples

If the intangible asset does not meet both the definition of an intangible asset and the recognition criteria, IAS 38 treats the expenditure on this item as an expense when it is incurred.<sup>23</sup>

### Example

FlyAway Travel Agency, an established provider of unique travel experiences to corporate clients, has agreed to sell its customer list to BeGone Travel Co. for \$1,500,000. Will the purchase of the customer list qualify as an asset on BeGone's books?

In order to answer this question, the constituent elements of the definition and criteria for recognition of an intangible asset must be considered:

- Identifiable—A distinct item has been purchased.
- Control—BeGone's control over the asset is established even though there are no legal rights attached to the asset because customer lists are commonly traded in exchange transactions

<sup>21</sup>IAS 38, ¶ 21.

<sup>22</sup>IAS 38, ¶ ¶ 22, 23.

<sup>23</sup>IAS 38, ¶ 58.



and in fact this customer list was purchased by BeGone in an exchange transaction.

- **Probability of Future Economic Benefit**—To recognize this asset, BeGone must determine that it is probable that its utilization of the customer list will result in future economic benefits (most likely in the form of future sales, but there could be other future benefits, such as revenue from the resale of the customer list).
- **Reliable Measurement**—BeGone can reliably measure the asset based on the amount it paid for the asset: \$1,500,000.

### Example

An example of an asset that may not result in an intangible asset is the recruitment and training of a workforce. The company must be able to exercise control over the asset. It is unlikely that a company would have sufficient control over a workforce to give access to future economic benefits.<sup>24</sup>

## C. Self-Created Intangible Assets

In general, internally generated or self-created intangibles are not recognized and the costs incurred to generate or create these intangibles are expensed as incurred under U.S. GAAP. However, there are some specific exceptions. These include certain industry-specific costs that are capitalized, such as internal-use software and website development costs.

### 1. Internally Developed Software

Software that is developed internally can fall into one of three buckets: (1) software that will be sold, leased, or otherwise marketed, (2) software that will be used internally but not in connection

<sup>24</sup>IAS 38, ¶ 15.

with research and development, and (3) software that will be used internally for research and development. Internally developed software that will be sold, leased, or otherwise marketed is accounted for under ASC 985-20. Internally developed software that will be used internally but not in connection with research and development is accounted for under ASC 350-40. Finally, internally developed software that is to be used internally for research and development is accounted for under ASC 730-10. When developing software, an entity must determine if the software will be for internal use (and thus accounted for under either ASC 350-20 or ASC 730-10) or will be marketed externally (and thus accounted for under ASC 985-20). Internal-use software is software that is acquired, internally developed, or modified solely to meet an entity's internal needs. Moreover, during its development or modification, there must be no substantive plan to market the software externally.<sup>25</sup> A plan to externally market software is a substantive plan only if implementation of the plan is reasonably possible. Evidence of a substantive plan includes the selection of a marketing channel with identified promotional, delivery, billing, and support activities. However, a routine market feasibility study does not, in itself, constitute a substantive plan to market software externally. Also, a cost-sharing or similar arrangement under which an entity agrees to develop software for mutual internal use does not disqualify the software as internal-use software.<sup>26</sup>

**Example**

Software that is designed for and embedded in a semiconductor chip that is in a product sold to a customer is externally marketed software. In contrast, software included in a telephone switch that a communications entity uses to sell telephone services is internal-use software because it is part of the internal equipment used to deliver a service and not part of a product or service acquired by the customer.<sup>27</sup>

<sup>25</sup>ASC 350-40-05-2.

<sup>26</sup>ASC 350-40-05-3.

<sup>27</sup>ASC 350-40-05-5.

Other examples of computer software or websites that are for internal use include:<sup>28</sup>

- Software developed to process payroll, accounts payable, accounts receivable, or improve cash management.
- Software developed by a telecommunications firm to run switches for its voice mail or call-forwarding services.
- Software developed to create components of music videos. The music videos are then sold without the software to a third party.
- Software developed to enhance the speed of services provided to customers.
- Costs to obtain and register an internet domain name for a website.
- Software developed to create websites, such as HTML editor, multimedia software, etc.
- Graphics development for websites, including design and layout of the website.
- Content development for websites, which may be textual or graphic in nature.

An increasingly popular product that typically qualifies as internal-use software is Software as a Service (SaaS). Rather than license software to customers, an SaaS company provides customers with the use of software on its own hosting platform. The customers in this instance pay for the use of the software but do not get a copy of the software for their own use. However, the Codification subjects hosting arrangements to the revenue guidance under ASC 985-605 regarding software to be externally marketed if such hosting arrangements meet both of the following criteria:

1. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
2. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

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<sup>28</sup>ASC 350-40-55-1.

The term *significant penalty* means the ability to take delivery of the software without incurring significant cost and the ability to use the software separately without a significant diminution in utility or value.<sup>29</sup> If the above two criteria are met and the arrangement must be treated as software to be externally marketed for revenue recognition purposes, then the reporting entity must be consistent and account for the costs to develop the software under ASC 985-20. If, on the other hand, the above criteria are not met and the SaaS is treated as internal-use software, the accounting rules in ASC 350-40 apply, which are described ahead under the subheading “Software Created for Internal Use Not in Connection with Research and Development.”

#### **Comment**

Only costs to develop and maintain the SaaS software are accounted for under ASC 350-40. Any direct customer acquisition costs (such as sales commissions or customer setup costs) must be accounted for separately from the ASC 350-40 costs. Specifically, direct customer acquisition costs may be expensed as incurred or capitalized and recognized proportionally over the same period that revenue from the customer contract is recognized. The election to either expense or capitalize such costs is an accounting policy decision that must be applied consistently and disclosed. The authority for making this accounting policy decision is SAB 13.A.3.f, Q&A 3 and 5, which recognizes such an accounting policy election for direct costs related to the acquisition or origination of a customer contract in a transaction that results in revenue deferral. Further support is found in a 2004 SEC Staff speech, which allows this accounting policy election for direct costs incurred in connection with specific customer contracts.<sup>30</sup>

Customers of hosting services account for their hosting fees under ASC 350-40. These rules are similar to the above rules

<sup>29</sup>ASC 985-605-55-121 and 55-122.

<sup>30</sup>SEC Staff Speech, Russell P. Hodge, Remarks before the 2004 AICPA National Conference on SEC and PCAOB Developments (Dec. 6, 2004).

under ASC 985–605 regarding how the provider of the hosting services accounts for revenue from the services. Specifically, from the customer’s perspective, a hosting contract is either (1) the acquisition of an intangible asset or (2) a service contract. A hosting contract amounts to the acquisition of an intangible asset by the customer if both of the following conditions are met:

1. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
2. It is feasible for the customer to either use the software on its own hardware or contract with another party unrelated to the vendor to host the software.<sup>31</sup>

The term “without significant penalty” in the first item means the ability to take delivery of the software without incurring significant cost and the ability to use the software separately without a significant diminution in utility or value.<sup>32</sup>

If the above criteria are met, the customer treats the hosting contract transaction as the acquisition of an intangible asset, which is recognized and measured under ASC 350-30-25-1 and ASC 350-30-30-1, respectively.<sup>33</sup> In contrast, if the above criteria are not met, the customer treats the hosting agreement as a service contract.<sup>34</sup>

#### Comment

ASU 2016-19 added ASC 350-40-25-17 to clarify the treatment of hosting contract transactions as acquisitions of intangible assets when they meet the above criteria. For entities that have not been applying the above rules, see ASC 350-40-65-2 for effective date and transitional information.

<sup>31</sup>ASC 350-40-15-4A.

<sup>32</sup>ASC 350-40-15-4B.

<sup>33</sup>ASC 350-40-25-17.

<sup>34</sup>ASC 350-40-15-4C.

*a. Software to Be Externally Marketed*

Costs of software that is to be sold, leased, or marketed also may be capitalized under certain circumstances. The accounting for this specific category of software intangible is covered in ASC 985, *Software*. In general, research and development costs are expensed as incurred. These costs are those incurred to establish the technological feasibility of the software. Once the technological feasibility of the software has been determined and all research and development activities have been completed, then certain costs can be capitalized, such as production and inventory costs.

*b. Software Created for Internal Use Not in Connection with Research and Development*

There are three stages to the development of internal-use software: the preliminary project stage, the application development stage, and the postimplementation-operation stage. There are separate rules for accounting for the costs incurred in each of these three stages. There also are rules on accounting for costs to upgrade and enhance internal-use software.

*(1) Preliminary Project Stage*

Internal and external costs incurred during the preliminary project stage are expensed as incurred.<sup>35</sup> The preliminary project stage typically includes the conceptual formulation of alternatives, evaluation of alternatives, determination of needed technology, and final selection of alternatives.<sup>36</sup> During this stage, entities typically make strategic decisions to allocate resources between alternative projects, determine what they need the software to do (i.e., determine the software's performance requirements), determine systems requirements for the software, explore alternative means of achieving specified performance requirements, determine whether the technology required to achieve performance requirements exists, and select a consultant to assist in the development or installation of the software.

<sup>35</sup>ASC 350-40-25-1.

<sup>36</sup>ASC 350-40-55-3(a).

## (2) Application Development Stage

Most internal and external costs incurred to develop internal-use software during this stage must be capitalized. Generally, this stage begins when both of the following occur:<sup>37</sup>

- a. The preliminary project stage is complete.
- b. Management authorizes and commits to funding the computer software and it is probable that the project will be completed and software used as intended.

The application development stage ends when either the project is substantially complete and the software is ready for its intended use (i.e., after all substantial testing is complete) or when it is no longer probable that the project will be completed.<sup>38</sup> If it is no longer probable that the project will be completed, the entity must perform impairment testing on the capitalized balance, described further ahead.<sup>39</sup>

The application development stage (when costs are capitalized) includes software configuration and interfaces, coding, hardware installation, and testing.<sup>40</sup>

## (3) Postimplementation-Operation Stage

Once all substantial testing is done and the application development stage is complete, meaning that the project is substantially complete and the software is ready for its intended use, the postimplementation-operation stage begins. In this stage, any internal or external training costs and maintenance costs are expensed as incurred.<sup>41</sup>

## (4) Upgrades and Enhancements

A project to upgrade or enhance internal-use software is treated as a new project if it is probable that the resulting costs will add

<sup>37</sup>ASC 350-40-25-12.

<sup>38</sup>ASC 350-40-25-14.

<sup>39</sup>ASC 350-40-25-13.

<sup>40</sup>ASC 350-40-55-3(b).

<sup>41</sup>ASC 350-40-25-6.

functionality to the existing software.<sup>42</sup> Therefore, any costs incurred during the preliminary project stage of an upgrade or enhancement project are expensed as incurred, as are costs incurred in the postimplementation-operation stage. In contrast, costs incurred during the application development stage are capitalized.<sup>43</sup>

If an upgrade or enhancement project is conducted in conjunction with regular maintenance of the existing software, the entity must distinguish between the upgrade/enhancement project costs and the maintenance costs (which are expensed as incurred).<sup>44</sup> However, if the upgrades and enhancements are relatively minor and there is no reasonably cost-effective way to distinguish between the costs to maintain and to upgrade or enhance the existing software, then the entity must expense all such costs as incurred.<sup>45</sup> Moreover, if the entity has contracted with a third party to perform these functions, it must allocate the contract costs between these functions. If the upgrades and enhancements are unspecified in such a contract, then the entity must recognize its contract costs over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received under the contract.<sup>46</sup>

### *c. Software Created for Use in Research and Development*

The costs of software to be created for use in research and development are expensed as incurred even if such software will have an alternative future use.<sup>47</sup>

#### **Comment**

Interestingly, if software for use in research and development activities is purchased through an asset acquisition, its costs are

<sup>42</sup>ASC 350-40-25-7.

<sup>43</sup>ASC 350-40-25-8.

<sup>44</sup>ASC 350-40-25-9; ASC 350-40-25-11.

<sup>45</sup>ASC 350-40-25-10.

<sup>46</sup>ASC 350-40-25-11.

<sup>47</sup>ASC 730-10-25-4.



capitalized if the software has an alternative future use (either in other research and development projects or otherwise) and the amortization deductions are treated as research and development expenses. Moreover, such software is recognized at its fair value when purchased in a business combination regardless of whether it has an alternative future use. Sections 1.D.1 and 1.E.4.b of this book discuss research and development intangibles acquired in asset acquisitions and business combinations, respectively.

## 2. Website Development

ASC 350-50 discusses the guidance on accounting for costs incurred to develop a website. That subtopic recognizes five stages in the development of a website—the planning stage, the website application and infrastructure development stage, the graphics development stage, the content development stage, and the operating stage. The accounting treatment of costs incurred in each of these stages varies.

### *a. Planning Stage*

Costs incurred during the planning stage are expensed as incurred even if they specifically relate to software.<sup>48</sup>

### *b. Website Application and Infrastructure Development Stage*

The various costs incurred in the website application and infrastructure development stage are treated as follows:

- Costs related to software to operate the website—such costs are accounted for as either internal-use software (under ASC 350-40)<sup>49</sup> or software to be marketed externally (under ASC 985-20).<sup>50</sup>

<sup>48</sup>ASC 350-50-25-2.

<sup>49</sup>See Section 1.C.1.b of this book for the rules on internal-use software.

<sup>50</sup>ASC 350-50-25-4. See Section 1.C.1.a of this book for the rules on software to be marketed externally.

- Fees incurred for website hosting—such fees are expensed over the period in which the hosting services are provided.<sup>51</sup>
- Costs incurred to purchase or internally develop software tools—such costs are capitalized if the entity does not plan to market the finished software externally, the costs are incurred during the application and infrastructure development stage, and the software tools are not related to research and development projects.<sup>52</sup>
- Costs to obtain and register an internet domain name—such costs are capitalized.<sup>53</sup>

#### *c. Graphics Development Stage*

The accounting treatment of costs incurred in the graphics development stage to develop initial graphics for a website are accounted for as either internal-use software (under ASC 350-40)<sup>54</sup> or software to be marketed externally (under ASC 985-20).<sup>55</sup> The accounting treatment of costs to modify the graphics once a website is launched depends on whether the modifications are done to merely maintain the website or to enhance it.<sup>56</sup>

#### *d. Content Development Stage*

Most costs incurred in the content development stage are expensed as incurred, including the cost to input the content and to convert data. However, the cost of software used to integrate a database with a website is capitalized.<sup>57</sup>

#### *e. Operating Stage*

Costs incurred during the operating stage are expensed unless they add to the website's functionality, in which case they are treated as creating new software and must be accounted for based on the above

<sup>51</sup>ASC 350-50-25-5.

<sup>52</sup>ASC 350-50-25-6.

<sup>53</sup>ASC 350-50-25-7.

<sup>54</sup>See Section 1.C.1.b of this book for the rules on internal-use software.

<sup>55</sup>See Section 1.C.1.a of this book for the rules on software to be marketed externally.

<sup>56</sup>ASC 350-50-25-8; ASC 350-50-25-9.

<sup>57</sup>ASC 350-50-25-10 through ASC 350-50-25-13.

rules.<sup>58</sup> Moreover, costs to register the website with Internet search engines represent advertising costs that are expensed under ASC 720-35-25-1.

### 3. Research and Development Activities

Generally, research and development (R&D) costs are expensed as they are incurred under ASC 730-10. This is because there is no indication that an economic resource has been created that would result in future economic benefits (which are uncertain). Although some future benefits from an R&D project are expected, they generally cannot be measured reliably. Also, there is little, if any, direct relationship between the amount of current R&D and the amount of future economic benefits.

Generally, R&D activities are aimed at developing or significantly improving: (1) a product or service, or (2) a process or technique. The end result can be intended for either sale or internal use. The guidance on R&D expenses in ASC 730-10, however, does not apply to the following situations:<sup>59</sup>

- a. Accounting for the costs of research and development activities conducted for others under a contractual arrangement. Also excluded are indirect costs that are reimbursable under the terms of a contract.
- b. Activities unique to entities in the extractive industries.
- c. The acquisition, development, or improvement of a process by an entity for use in its selling or administrative activities, which also includes certain computer software costs used in an entity's selling and administrative activities.
- d. Routine or periodic alterations to existing products, production lines, manufacturing processes, and other ongoing operations even though these may represent improvements.
- e. Market research or market testing activities.
- f. Research and development assets acquired in a business combination or an acquisition by a not-for-profit entity. These are measured at fair value as of the acquisition date. (*See* Section 5115.1.E.4.b.)

<sup>58</sup>ASC 350-50-25-14 through ASC 350-50-25-17.

<sup>59</sup>ASC 730-10-15-4.

The costs associated with R&D activities fall into the following five categories:<sup>60</sup>

1. *Materials, equipment, and facilities*—costs of materials, equipment, and facilities acquired or constructed for research and development activities. If these costs have future alternative uses (whether in research and development activities or not), then these costs must be capitalized as tangible assets. If these costs are capitalized, then the consumption costs and depreciation expense of the tangible asset related to research and development activities must be included in research and development costs on the income statement. But if these costs do not have future alternative uses, then the costs are considered research and development costs and must be expensed as incurred (i.e., the costs are not capitalized).
2. *Personnel*—salaries, wages, and other related costs of personnel engaged in research and development activities. These personnel costs must be included in research and development costs and expensed as incurred.
3. *Intangible assets purchased from others*—costs of intangible assets purchased from others for use in research and development activities. If these costs have future alternative uses (whether in research and development activities or not), then these costs must be accounted for in accordance with ASC 350, which typically means they are capitalized and amortized. The amortization of the intangible asset related to research and development activities must be included in research and development costs and expensed in each appropriate reporting period. But if these costs do not have future alternative uses, then the costs are considered research and development costs and must be expensed as incurred (i.e., the costs are not capitalized).
4. *Contract services*—costs performed by others in connection with the research and development activities. These contract costs must be included in research and development costs and expensed as incurred.
5. *Indirect costs*—indirect costs that can be reasonably allocated and are clearly related to research and development activities. These indirect costs must be included in research and development costs and expensed as incurred.

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<sup>60</sup>ASC 730-10-25-2.

#### 4. IFRS Rules on Internally Generated Intangible Assets

As with U.S. GAAP, under IFRS internally generated goodwill is not recognized as an asset. However, IFRS is more liberal in allowing internally generated intangible asset recognition. Under U.S. GAAP only certain types of development activities may be capitalized with a resultant intangible asset, for example, software. In contrast, IFRS allows development activities, in general, to be capitalized if they meet certain criteria. IFRS does not restrict this capitalization of internally generated intangible assets to a few industries like U.S. GAAP does.

Difficulties arise in determining whether internally generated intangible assets qualify for recognition because of problems in identifying them and determining their costs in a reliable manner. The entity must be able to classify the generation of an intangible asset into a research phase and a development phase. Costs incurred in the research phase are expensed as incurred because the IASB believes an entity cannot yet demonstrate that an intangible asset exists that will generate probable future economic benefits. In contrast, certain costs incurred in the development phase may lead to the recognition of an intangible asset. If it is not possible for an entity to determine whether a cost should be allocated to the research phase or the development phase, then it is expensed as incurred.<sup>61</sup>

To recognize an internally generated intangible asset arising during the development phase, an entity must demonstrate all of the following:

- a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- b. Its intention to complete the intangible asset and use or sell it.
- c. Its ability to use or sell the intangible asset.
- d. How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset. An entity should use the principles

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<sup>61</sup>IAS 38, ¶¶ 51-56.

in IAS 36, ¶¶ 33–57 (concerning impairment of assets) to assess future economic benefits.<sup>62</sup>

- e. The availability of adequate technical, financial, and other resources to complete the development and to use or sell the intangible asset. This requirement can be demonstrated, for example, through a business plan or a lender's indication of its willingness to provide the necessary financing to complete the asset's development.<sup>63</sup>
- f. Its ability to measure reliably the expenditure attributable to the intangible asset during its development.<sup>64</sup>

An entity must determine to which phase activities (and their costs) should be assigned. Examples of activities during the research phase are as follows:

- 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
- The formulation, design, evaluation, and final selection of possible alternatives for new or improved materials, devices, products, processes, systems, or services<sup>65</sup>

Examples of activities during the development phase are as follows:

- Design of tools and dies involved in new technology
- Design, construction, and testing of pre-production prototypes or models
- Design, construction, and testing of a chosen alternative for new/improved materials, products, processes, systems, or services
- Design, construction, and operation of a pilot plant that is smaller in scale to the commercially feasible production plant<sup>66</sup>

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<sup>62</sup>IAS 38, ¶ 60.

<sup>63</sup>IAS 38, ¶ 61.

<sup>64</sup>IAS 38, ¶ 57.

<sup>65</sup>IAS 38, ¶ 55.

<sup>66</sup>IAS 38, ¶ 59.

Certain items that cannot be distinguished from the cost of developing the business as a whole should not be recognized as intangible assets. Such items include internally generated brands, mastheads, publishing titles, customer lists, and items similar in substance.<sup>67</sup>

**Comment**

Some companies might want to apply a quantitative threshold such that only expenditures on projects above a predetermined amount would be considered for capitalization. IAS 38, however, requires development costs to be capitalized once the criteria have been met. Therefore, by not capitalizing all costs these companies would technically be using a non-IFRS-compliant accounting policy. These companies would need to have processes in place that would support the conclusion that these amounts are immaterial both in the period the costs are incurred and in subsequent periods.

**Comment**

IFRS will result in more costs being capitalized compared to U.S. GAAP. However, the effect on profit should even out over the period from development of an asset to the end of its useful life.

**D. Intangible Assets Acquired in an Asset Acquisition**

Outside of the business combination context, intangible assets may be acquired individually or through an asset acquisition, that is, with a group of other assets in a transaction that does not qualify as a business combination. Guidance on accounting for asset acquisitions is in ASC 805-50, but the guidance on recognizing intangible assets acquired through an asset acquisition is in ASC 350-30. The IFRS rules on intangible assets acquired in asset acquisitions are in IAS 38.

<sup>67</sup>IAS 38, ¶¶ 63 and 64.

## 1. U.S. GAAP

Under U.S. GAAP, the cost of a group of assets acquired (with or without liabilities) in a transaction other than a business combination is allocated to the individual assets and any liabilities assumed based on their relative fair values and does not result in any goodwill being recognized.<sup>68</sup>

### Example

On January 1, 20X4, X Corp. acquired a group of assets when it purchased land, buildings, equipment, and a patent (intangible asset) for \$1,500,000 in cash. Transaction costs of \$50,000 were incurred and are included in the purchase price to be allocated to the acquired assets.<sup>69</sup>

To allocate the cost, the fair value of the individual assets is determined based on fair value measurement guidance from ASC 820.

Asset	Fair Value	Percent of Total Fair Value	×	Purchase Price + Transaction Costs	=	Allocated Cost of Assets Acquired + Transaction Costs
Land	\$680,000	40% <sup>(a)</sup>		\$1,550,000		\$620,000
Building	340,000	20% <sup>(b)</sup>		1,550,000		310,000
Equipment	170,000	10% <sup>(c)</sup>		1,550,000		155,000
Patent	510,000	30% <sup>(d)</sup>		1,550,000		465,000
Total	<u>\$1,700,000</u>	<u>100%</u>				<u>\$1,550,000</u>

<sup>(a)</sup> 680,000/1,700,000 = 40 percent

<sup>(b)</sup> 340,000/1,700,000 = 20 percent

<sup>(c)</sup> 170,000/1,700,000 = 10 percent

<sup>(d)</sup> 510,000/1,700,000 = 30 percent

<sup>68</sup> ASC 805-50-30-3; ASC 350-30-25-2.

<sup>69</sup> ASC 805-50-30-1.



**Comment**

In this example, when acquiring a group of assets, the “allocated fair value” does *not* equal the “fair value” per ASC 820. If the fair value of the consideration does not equal the collective fair values of the assets acquired, then each asset’s fair value must be adjusted to reflect the asset’s proportionate share of the consideration. In a normal business combination, these assets would have been measured at fair value per ASC 820, with no adjustment or allocation. The patent in this example is measured at allocated fair value of \$465,000, *not* fair value of \$510,000. In a business combination the patent would have been measured at fair value of \$510,000.

There are two sets of rules under which an intangible asset may be identified in an asset acquisition. First, an intangible asset is identifiable if it meets the definition of identifiable under the business combination rules in ASC 805.<sup>70</sup> The definition of an identifiable intangible asset under those rules is: an intangible asset that meets one or both of the following criteria:<sup>71</sup>

- a. *Separability criterion.* An intangible asset is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so.
- b. *Contractual-legal criterion.* An intangible asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

If an intangible asset acquired in an asset acquisition does not meet either of these criteria, then it still may be recognized if it meets the asset recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of*

<sup>70</sup>ASC 350-30-25-4.

<sup>71</sup>ASC 805-20-25-10; ASC Term “Identifiable.”

*Business Enterprises (CON 5)*. CON 5 states that an asset must have a relevant attribute that can be quantified in monetary units with sufficient reliability. The FASB Codification gives two examples of intangible assets that may meet this CON 5 definition: specially trained employees and a unique manufacturing process related to a manufacturing plant acquisition. The Codification states that such transactions are bargained exchange transactions conducted at arm's length, which provides objective and reliable evidence of the existence and fair value of those assets, resulting in their recognition as intangible assets.<sup>72</sup>

Interestingly, an intangible asset related to specially trained employees, sometimes referred to as an assembled workforce, can be recognized in an asset acquisition but it cannot be recognized in a business combination.<sup>73</sup> However, while it is theoretically possible to have acquired an assembled workforce intangible asset in an asset acquisition, the presence of this type of intangible asset may indicate that the transaction was actually a business combination. Specifically, a business combination is defined as a transaction or other event in which the acquirer obtains control of one or more businesses.<sup>74</sup> Key to this definition is the concept of acquiring a "business." A business is defined as an integrated set of activities and assets capable of being conducted and managed for the purpose of providing either (1) a return to investors or (2) dividends, lower costs, or other economic benefits directly and proportionately to owners, members, or participants.<sup>75</sup> A business consists of inputs and processes applied to those inputs that have an ability to contribute to the creation of outputs.<sup>76</sup> Therefore, if an entity purchases both a group of assets and the trained workforce necessary to use those assets, it may have taken control of a business and thus must apply the business combination rules, which do not permit the recognition of an assembled workforce intangible asset.

The asset acquisition and business combination rules also diverge in the area of the acquisition of in-process research and development

<sup>72</sup>ASC 350-30-25-4.

<sup>73</sup>ASC 805-20-55-6. This guidance has been amended by ASU 2017-01.

<sup>74</sup>ASC Term "Business Combination."

<sup>75</sup>ASC Term "Business."

<sup>76</sup>ASC 805-10-55-4.

(IPR&D). In an asset acquisition, amounts allocated to IPR&D are expensed in the period of the acquisition if the IPR&D has no alternative future use. If the IPR&D has an alternative future use, the amount allocated to it is amortized over the IPR&D's estimated useful life, with the amortization in each period characterized as research and development costs.<sup>77</sup> In contrast, IPR&D acquired in a business combination is recognized and carried as an asset regardless of whether it has an alternative future use.<sup>78</sup> See Section 1.E.4.c for the rules on IPR&D acquired in a business combination.

### Planning Point

If the purchase price exceeds the collective fair values of the identified acquired assets (thus requiring an allocation of greater than fair value to each asset), then the entity should reexamine the assets it purchased to determine if there are additional intangible assets that it may have overlooked. Similarly, if the purchase price is less than the collective fair values of the identified acquired assets (thus requiring an allocation of less than fair value to each asset), then the entity should determine if there are any IPR&D or contingent liabilities that it overlooked. Any identified IPR&D would receive a purchase price allocation and be treated as indicated above. Any contingent liabilities should receive a purchase price allocation based on their fair values.

## 2. IFRS

The IFRS rules are very similar to U.S. GAAP when an entity acquires an intangible asset separately but IFRS analyzes such a transaction in the context of its general recognition principles for all intangible assets within the scope of IAS 38. Those principles, explained more thoroughly in Section 1.B of this book, state that an identifiable intangible asset is recognized when: (1) it is probable that the

<sup>77</sup>ASC 730-10-25-2(c).

<sup>78</sup>ASC 805-20-35-5.

expected future economic benefits from the asset will flow to the entity, and (2) the cost of the asset can be measured reliably.<sup>79</sup>

The first recognition criterion is always considered to be satisfied in an asset acquisition because normally the price the entity pays to acquire the intangible reflects expectations about the probability that the expected future economic benefits will flow to the entity, even if there is some uncertainty about the timing and amount of that inflow.<sup>80</sup> Similarly, the second recognition criterion is typically met also because usually the costs of a separately acquired intangible asset can be measured reliably, especially when the purchase consideration is in the form of cash or other monetary assets.<sup>81</sup> If the payment for an intangible asset is deferred beyond normal credit terms, its cost is its cash price equivalent. IAS 38 states that the cost of a separately acquired intangible asset comprises:

1. Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates
2. Any directly attributable cost of preparing the asset for its intended use<sup>82</sup>

Examples of directly attributable costs are:

1. Costs of employee benefits (as defined in IAS 19) arising directly from bringing the asset to its working condition
2. Professional fees arising directly from bringing the asset to its working condition
3. Costs of testing whether the asset is functioning properly<sup>83</sup>

Examples of expenditures that are not part of the cost of an intangible asset are:

1. Costs of introducing a new product or service (including costs of advertising and promotional activities)

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<sup>79</sup>IAS 38, ¶ 21.

<sup>80</sup>IAS 38, ¶ 25.

<sup>81</sup>IAS 38, ¶ 26.

<sup>82</sup>IAS 38, ¶ 27.

<sup>83</sup>IAS 38, ¶ 28.

2. Costs of conducting business in a new location or with a new class of customer (including costs of staff training)
3. Administration and other general overhead costs<sup>84</sup>

One difference between IFRS and U.S. GAAP in the asset acquisition context is the recognition of the assembled workforce intangible. As noted in the previous section, U.S. GAAP permits the recognition of such an intangible in an asset acquisition (but not in a business combination) while IFRS does not permit recognition of an assembled workforce in either type of transaction.<sup>85</sup>

### 3. Acquired Defensive Intangible Assets

#### *a. U.S. GAAP*

Defensive intangibles assets are acquired intangibles assets that the entity does not intend to ever use, or assets that the entity will use only during a transition period with the intent that use will be discontinued after that period has ended.<sup>86</sup> The determination of whether an asset is a defensive intangible asset is based on the intentions of the reporting entity. These intentions may change at a later date.<sup>87</sup>

#### **Example**

X Corp. buys a competing trade name, but intends to hold the rights to the trade name to prevent others from using it. The trade name was acquired in a separate transaction for \$1,000,000. This trade name meets the definition of a defensive intangible asset. However, suppose X Corp. decides to actively use this trade name at a later date. At that point, it would cease to be a defensive asset and may need to be revalued.

The allocated cost of a defensive intangible asset that the entity does not intend to use or intends to use in a way that is not its highest

<sup>84</sup>IAS 38, ¶ 29.

<sup>85</sup>IAS 38, ¶ 15.

<sup>86</sup>ASC 350-30-55-1.

<sup>87</sup>ASC 350-30-55-1B.

and best use, such as a brand or trade name, must be determined based on its relative fair value per ASC 820. ASC 820 requires that fair value is measured at the asset's highest and best use to market participants, regardless of its intended use. However, ASC 820 states that an asset provides defensive value when it prevents an entity's competitors from accessing the economic benefits of the asset, thereby improving the prospects for the entity's own competing asset. Thus, an entity should consider the defensive value when determining an asset's highest and best use.<sup>88</sup>

A defensive intangible asset's useful life is the period over which an entity consumes the expected benefits of the asset. It is determined by estimating the period over which the defensive intangible asset will diminish in fair value, which is a proxy for the period over which the reporting entity expects the asset to contribute directly or indirectly to the future cash flows of the entity. It would be rare for a defensive intangible asset to have an indefinite life because the fair value of the defensive intangible asset will generally diminish over time as a result of a lack of market exposure or as a result of competitive or other factors.<sup>89</sup>

#### *b. IFRS*

In the context of a business combination, IFRS 3(R) implicitly requires the recognition of defensive intangible assets, at least for trade names, and practice has addressed initial measurement and subsequent accounting. Similar to U.S. GAAP, IFRS states, "For competitive or other reasons, the acquirer may intend not to use an acquired asset, for example, a research and development intangible asset, or it may intend to use the asset in a way that is different from the way in which other market participants would use it. Nevertheless, the acquirer shall measure the asset at fair value determined in accordance with its use by other market participants."<sup>90</sup>

<sup>88</sup>ASC 820-10-55-32.

<sup>89</sup>ASC 350-30-35-5A; ASC 350-30-35-5B. It should be noted that IPR&D assets are specifically scoped out of this guidance.

<sup>90</sup>IFRS 3(R), ¶ B43.

## E. Intangible Assets Acquired through a Business Combination

Intangible assets acquired in a business combination are recognized and initially measured under ASC 805. Many of these intangible assets had not been recognized previously because they were internally generated intangibles that were not allowed to be recognized under U.S. GAAP.<sup>91</sup> These acquired intangible assets are subsequently accounted for under ASC 350.

### Comment

The basic rules under ASC 805 for recognizing intangible assets in a business combination are also used for recognizing intangible assets in an acquisition by a not-for-profit entity. However, there are some unique rules under ASC 958-805 that apply to certain intangible assets involved in acquisitions by not-for-profit entities. See APPS 5203, *Accounting for Mergers and Acquisitions of Not-for-Profit Entities*, Section 6.D, for the rules on recognizing intangible assets in such transactions.

A business combination occurs when an acquirer obtains control of one or more businesses.<sup>92</sup>

ASC 805 applies the acquisition method to business combinations.<sup>93</sup> The steps in the application of the acquisition method require:

- a. Identifying the acquirer
- b. Determining the acquisition date
- c. Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
- d. Recognizing and measuring goodwill or a gain from a bargain purchase<sup>94</sup>

<sup>91</sup> See Section 1.C of this book for a discussion of internally generated intangibles.

<sup>92</sup> ASC Term “Business Combination.”

<sup>93</sup> The acquisition method is similar for both IFRS (IFRS 3(R)) and ASC 805.

<sup>94</sup> ASC 805-10-05-4.

**EXHIBIT 1.2** Treatment of Intangible Assets

<b>Internally Generated Intangible Assets</b>	<b>Acquired Intangible Assets</b>		
	Goodwill	Intangible Assets Other Than Goodwill	
		Finite Lives	Indefinite Lives
Not Recognized	Recorded at Fair Value	Recorded at Fair Value	Recorded at Fair Value
	Not Amortized	Amortized	Not Amortized

In addition to these four steps, an acquirer also must determine the fair value of the consideration it has paid, as that amount is allocated to all of the acquired assets and liabilities, with any residual being assigned to goodwill.

### 1. Determining the Fair Value of the Consideration

The acquisition price under ASC 805 is generally the fair value of the consideration paid for its interest in the acquiree. This consideration can include cash and other assets, equity interests, and contingent consideration; all of these are measured at fair value at the acquisition date.<sup>95</sup> Transaction and other acquisition-related costs are excluded from the acquisition accounting and are expensed in the period in which they are incurred.<sup>96</sup>

In many instances, the acquirer of a business may agree to transfer additional consideration (such as additional equity interests, cash, or other assets) to the former owners of the business if the business meets certain specified targets after the acquisition. The purpose of this contingent consideration is beneficial to both parties in that it helps to ensure a smoother transition to the new owner of the business.

<sup>95</sup>ASC 805-30-30-7.

<sup>96</sup>ASC 805-10-25-23. Examples of transaction and other acquisition-related costs are finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities.



The former owner benefits from this structure in that contingent consideration (earn-outs) is recorded at fair value on the acquisition date, with changes in fair values generally being recorded through earnings each reporting period thereafter.<sup>97</sup>

## 2. Identifying the Acquirer

A key concept in ASC 805 is that a business combination occurs when one business entity gains control over another business entity. The business entity gaining control is termed as the acquirer. In most cases, identifying the acquirer is straightforward, but in some instances it is not.

## 3. Determining the Acquisition Date

The acquisition date is the date on which the acquirer obtains control of the acquiree. Change of control is typically demonstrated when the acquirer transfers the consideration and obtains responsibility over the assets acquired and liabilities assumed. This often occurs on the closing date of the transaction.<sup>98</sup>

## 4. Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree

The acquirer must recognize the full fair value of acquired identified intangible assets, including goodwill. U.S. GAAP establishes that an intangible asset is identifiable if it meets either of the following criteria:<sup>99</sup>

- a. *Separability criterion*: An intangible asset is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so.

<sup>97</sup>ASC 805-30-25-5.

<sup>98</sup>ASC 805-10-25-7.

<sup>99</sup>ASC 805-20-25-10; ASC Term “Identifiable.”

- b. *Contractual-legal criterion*: An intangible asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

### Comment

This test is modified for private companies.<sup>100</sup> The next section discusses the accounting alternative election available to private companies that permits them to not recognize noncompetition agreements and certain customer-related intangibles even if they meet the above criteria.

An intangible asset meets the contractual-legal criterion if it arises from contractual or other legal rights. An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations.<sup>101</sup>

The following are examples of intangible assets that meet the contractual-legal criterion:

- An acquiree leases a manufacturing facility under an operating lease that has terms that are favorable relative to market terms. The lease terms explicitly prohibit transfer of the lease (through either sale or sublease). The amount by which the lease terms are favorable compared with the pricing of current market transactions for the same or similar items is an intangible asset that meets the contractual-legal criterion for recognition separately from goodwill, even though the acquirer cannot sell or otherwise transfer the lease contract.<sup>102</sup>
- An acquiree owns and operates a nuclear power plant. The license to operate that power plant is an intangible asset that meets the contractual-legal criterion for recognition separately from

<sup>100</sup>ASC 805-20-25-1 (pending content).

<sup>101</sup>ASC 805-20-55-2. *See also* ASC 805-20-25-10.

<sup>102</sup>ASC 805-20-55-2(a). *See also* ASC 805-20-25-12 and ASC 805-20-25-13.

goodwill, even if the acquirer cannot sell or transfer it separately from the acquired power plant. An acquirer may recognize the fair value of the operating license and the fair value of the power plant as a single asset for financial reporting purposes if the useful lives of those assets are similar.<sup>103</sup>

- An acquiree owns a technology patent. It has licensed that patent to others for their exclusive use outside the domestic market, receiving a specified percentage of future foreign revenue in exchange. Both the technology patent and the related license agreement meet the contractual-legal criterion for recognition separately from goodwill even if selling or exchanging the patent and the related license agreement separately from one another would not be practical.<sup>104</sup>

The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something else of value meets the separability criterion regardless of whether the acquirer intends to sell, license, or otherwise exchange it.<sup>105</sup>

An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them.<sup>106</sup> For example, customer and subscriber lists are frequently licensed and thus generally meet the separability criterion. Even if an acquiree believes its customer list has characteristics different from other customer lists, the fact that customer lists are frequently licensed generally means that the acquired customer list meets the separability criterion. However, a customer list would not meet the separability criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing, or otherwise exchanging information about its customers.<sup>107</sup>

<sup>103</sup>ASC 805-20-55-2(b).

<sup>104</sup>ASC 805-20-55-2(c).

<sup>105</sup>ASC 805-20-55-3.

<sup>106</sup>ASC 805-20-55-4.

<sup>107</sup>ASC 805-20-55-4.

An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset, or liability.<sup>108</sup>

The following are examples of intangible assets that meet the separability criterion:

- An acquiree has regular contact with its customer base, who routinely place orders on the acquiree's website and through the company's customer service function. These customer relationships meet the separability criterion because: (1) the acquirer has regular contract with its customers, (2) the acquirer retains information about the customers, and (3) the customers can make direct contact with the acquirer.<sup>109</sup>
- Market participants exchange deposit liabilities and related depositor relationship intangible assets in observable exchange transactions. Therefore, the acquirer should recognize the depositor relationship intangible asset separately from goodwill.<sup>110</sup>
- An acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. To transfer ownership of a trademark, the owner is also required to transfer everything else necessary for the new owner to produce a product or service indistinguishable from that produced by the former owner. Because the unpatented technical expertise must be separated from the acquiree or combined entity and sold if the related trademark is sold, it meets the separability criterion.<sup>111</sup>

#### *a. Accounting Alternative for Private Companies*

ASU 2014-18 has created an accounting alternative for private companies that are required to recognize or consider the fair value of intangible assets as a result of:

<sup>108</sup>ASC 805-20-55-5.

<sup>109</sup>ASC 805-20-55-25.

<sup>110</sup>ASC 805-20-55-5(a).

<sup>111</sup>ASC 805-20-55-5(b).

- Applying the acquisition method;
- Assessing the nature of the difference between the carrying amount and underlying equity in the assets of an investee when applying the equity method of accounting (which occurs during the acquisition of an equity method investment); or
- Adopting fresh-start reporting in a reorganization transaction under ASC 852.<sup>112</sup>

This accounting alternative, if elected, permits a private company to forgo separately identifying and valuing certain customer-related intangible assets and noncompetition agreements. The value of these assets would simply flow through to the residual value of the goodwill. If a private company elects this accounting alternative, it also must elect the goodwill alternative, though the reverse is not true in that an entity that has elected the goodwill alternative need not elect this identifiable intangible assets accounting alternative.<sup>113</sup>

#### (1) Timing of Accounting Alternative Election

This election may be made upon the occurrence of the first transaction identified above in fiscal years beginning after December 15, 2015, or upon the occurrence of an identified transaction before this date.<sup>114</sup> If the entity does not adopt this accounting alternative on the first occurrence of an identified transaction after December 15, 2015, it may only adopt the accounting alternative in the future as an accounting change under ASC 250, subject to all the requirements therein. Once elected, the accounting alternative applies to all future transactions.<sup>115</sup>

#### (2) Application of Accounting Alternative

If elected, the accounting alternative allows a private company to recognize identifiable intangible assets in goodwill if they are:

<sup>112</sup>ASC 805-20-15-2.

<sup>113</sup>ASC 805-20-15-4. The goodwill alternative permits an entity to amortize goodwill over a period not exceeding 10 years.

<sup>114</sup>ASC 805-20-65-2. Note that on July 21, 2015, the Private Company Council voted to develop a proposal that would allow private companies to make an unconditional one-time election to adopt a PCC alternative without demonstrating the preferability of that alternative.

<sup>115</sup>ASC 805-20-15-3.

- Customer-related assets that cannot be sold separately from other business assets; or
- Noncompetition agreements.<sup>116</sup>

Contract assets (an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time) and leases are not considered customer assets and may not be subsumed into goodwill.<sup>117</sup> Contract assets are not customer-based intangible assets because they will eventually be reclassified as a receivable.<sup>118</sup> However, the Basis for Conclusions in ASU 2014-18 indicates that intangible assets based on the favorableness of customer contracts can be subsumed into goodwill. The value of an intangible asset based on the favorableness of customer contracts cannot be offset by the unfavorableness of other customer contracts, as that value constitutes a liability.<sup>119</sup>

This accounting alternative also applies to all noncompetition agreements that are acquired in a business combination (or in one of the other types of qualifying transactions). A private company need not determine if such agreements are capable of being sold or licensed separately from the other assets of the business. The FASB notes, however, in its Basis for Conclusions that some accountants consider noncompetition agreements entered into as a result of a business combination to be an asset acquired in the business combination while others do not. The FASB decided not to address this diversity in practice, noting that if it chooses to address the issue, it should do so in a project that would affect all companies, not just private companies.<sup>120</sup> Thus, it appears that a private company may subsume the value of these noncompetition agreements into goodwill if it treats such agreements as assets acquired in a business combination. However, many public accounting firms may not permit such treatment.

<sup>116</sup>ASC 805-20-25-30.

<sup>117</sup>ASC 805-20-25-31; ASC 805-20-25-32.

<sup>118</sup>ASU 2014-18, ¶ BC 20.

<sup>119</sup>ASU 2014-18, ¶ BC 21.

<sup>120</sup>ASU 2014-18, ¶ BC 19.

**Big Firm Position**

Ernst & Young, KPMG, and PricewaterhouseCoopers believe that noncompetition agreements are separate transactions from the business combination that leads to their creation. Ernst & Young has also specifically opined that it believes such agreements are not subject to this accounting alternative.<sup>121</sup>

If a private company wants to change the way in which it has been treating noncompetition agreements as a result of FASB's recognition that there is diversity in practice, it would have to treat the change as a voluntary change in accounting principle and follow the rules in ASC 250-10. Thus, it would have to justify the change and apply the change retroactively.<sup>122</sup>

The above analysis applies to noncompetition agreements entered into as a result of a current business combination (or other transaction qualifying for the accounting alternative). When a qualifying transaction occurs, such as a business combination, however, the acquired company may have noncompetition agreements from prior transactions that are still in force. If the acquired company had treated these agreements as part of prior acquisitions, the agreements will appear on its balance sheet, but if it treated these agreements as transactions that are separate from the prior acquisitions, then the agreements will not appear on its balance sheet. In either event, these agreements are intangible assets acquired through the current acquisition (or other qualifying transaction) that can be subsumed into goodwill if the private company acquirer elects this accounting

<sup>121</sup>Ernst & Young, *Private Companies Can Recognize Fewer Intangible Assets Acquired in a Business Combination*, To the Point, No. 2015-01 (January 7, 2015); PricewaterhouseCoopers, *Business Combinations and Noncontrolling Interests, Accounting Guides* (September 2014); KPMG, *Accounting for Business Combinations and Noncontrolling Interests*, Department of Professional Practice (January 2012). See also, Ernst & Young, *Business Combinations*, Financial Reporting Developments (December 2014).

<sup>122</sup>See ASC 250-10-45-2; ASC 250-10-45-4.

alternative. Unlike the rules regarding customer-related intangibles, there is no caveat that limits application of the accounting alternative to only unrecognized noncompetition agreements.

#### *b. Contingent Assets and Liabilities*

Assets and liabilities that are of a contingent nature (i.e., preacquisition contingencies) are recorded at their fair values as of the acquisition date.

Previously, under FAS 141, the fair value of a preacquisition contingency was included in the purchase price allocation if that fair value could be determined within the allocation period. If it could not, then the estimated amount of the contingent asset or liability was included in the purchase price allocation if: (1) information available prior to the end of the allocation period indicated that it was probable that an asset existed, a liability had been incurred, or an asset had been impaired at the consummation of the business combination, and (2) the amount of the asset or liability could be reasonably estimated. FAS 141 referred to the guidance in FAS 5 and FASB Interpretation No. 14 (now both codified in ASC 450-20) for applying the above rules.<sup>123</sup> Specifically, the FAS 5 guidance discussed the probability threshold and the reasonably estimated standard.

The treatment of preacquisition contingencies remained essentially unchanged under FAS 141(R), which represents the current codified rules in ASC 805. Specifically, preacquisition contingencies acquired in a business combination are to be measured at their respective fair values if they: (1) would be covered by ASC 450 if not acquired or assumed in a business combination, or (2) are not covered by a specific provision in ASC 805. Contingent assets and liabilities meeting this definition are recognized at their fair values as of the acquisition date if they can be measured within the measurement period (i.e., essentially within one year of the acquisition date). If they cannot be measured within the measurement period, contingent assets and liabilities, nonetheless, still must be recognized based on estimated values (as opposed to fair values)

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<sup>123</sup>FAS 141, ¶ 40 (superseded).



at the acquisition date if information available before the end of the measurement period indicates it is probable that an asset has been acquired or a liability has been incurred and the amount of the asset or liability can be reasonably estimated. These criteria are applied using the guidance in ASC 450-20 concerning the probability threshold and the reasonably estimated standard. If the contingency does not meet this probability threshold or cannot be reasonably estimated, then it is not accounted for as an asset or liability related to the business combination, but rather is accounted for under other Codification subtopics (including the contingency subtopic—ASC 450).<sup>124</sup>

### Comment

One interesting aspect of this provision is estimating the fair value of any potential lawsuits that the acquired company may be exposed to as of the date of acquisition. One way to measure the fair value of this contingency would be to estimate the range of likely outcomes. In order to estimate the fair value of the contingency, management of the acquirer would have to estimate and possibly disclose their estimate of the range of possible outcomes and the probability of each outcome. There may be a concern by some that this sort of disclosure could possibly hinder any settlement negotiations.

Under U.S. GAAP recognition of these liabilities would be done at the lower point of the range of possible outcomes as long as all points within the range are equally probable.<sup>125</sup> IFRS recognition criteria, found in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, are very similar to U.S. GAAP in most respects. However, for IFRS the estimate of the liability would be at the midpoint of the range, or the expected value.<sup>126</sup>

<sup>124</sup>ASC 805-20-25-18A through ASC 805-20-25-20B.

<sup>125</sup>ASC 450-20-30-1.

<sup>126</sup>IAS 37, ¶ 39.

**Example**

X Corp. acquires Z Co., which has a contingent liability from a possible legal settlement. Legal counsel has estimated that the liability range could be between \$1,000,000 and \$5,000,000. It is probable that a settlement will be required. Therefore, the contingent liability is both probable and reasonably estimable. What would be the recognized contingent liability under U.S. GAAP? Under IFRS?

Under U.S. GAAP the contingent liability would be recognized for \$1,000,000.

Under IFRS the contingent liability would be recognized for \$2,500,000.

*c. In-Process Research and Development (IPR&D)*

One interesting provision in ASC 350 that is a change from historic practice is the treatment of in-process research and development (IPR&D) in a business combination. Since the potential viability of any technology under development is somewhat speculative, the historic accounting treatment has been to expense research and development costs as they are incurred. This philosophy had been carried over to the allocation of any in-process technology acquired in a business combination. As such, under this treatment the fair value of in-process research and development under FAS 141 was currently expensed as of the date of the acquisition.

Now, the acquirer is required to recognize the IPR&D as an asset apart from goodwill regardless of whether it has an alternative future use. Moreover, IPR&D is deemed to be indefinite-lived until the completion or abandonment of the research and development activities.<sup>127</sup> If, at the completion or abandonment of the research and development activities, the IPR&D has an alternative future use, it is assigned a life if possible and accounted for under ASC 350.<sup>128</sup>

<sup>127</sup>ASC 805-20-35-5; ASC 350-30-35-17A.

<sup>128</sup>See Section 4.A of this book for the general rules on estimating the useful life of intangible assets for guidance on estimating the useful life of IPR&D upon completion of the research and development activities.

If it does not have an alternative future use, its carrying amount is expensed.

This revision to the IPR&D rules leaves some accounting inconsistencies in the treatment of IPR&D, which will have to be addressed in the future. Specifically, while IPR&D acquired in a business combination is recognized as an asset apart from goodwill, subsequent expenditures for research and development are still to be expensed. Also, if IPR&D is purchased as an asset apart from a business combination, the acquisition price for the IPR&D is still expensed at the time of the acquisition if it has no alternative future use.<sup>129</sup>

Similar to U.S. GAAP, under IFRS an acquirer recognizes as an asset separately from goodwill an in-process research and development project of the acquiree, if the project meets the definition of an intangible asset. An acquiree's in-process research and development project meets the definition of an intangible asset when it: (1) meets the definition of an asset; and (2) is identifiable (i.e., is separable or arises from contractual or other legal rights).<sup>130</sup> An asset is defined in IAS 38 as a resource (1) that is controlled by an entity as a result of past events and (2) from which future economic benefits are expected to flow to the entity.<sup>131</sup>

#### *d. Assembled Workforce*

An acquirer may not separately recognize an assembled (or trained) workforce as a separate asset acquired in a business combination.<sup>132</sup> This rule is in contrast to an assembled workforce acquired in an asset acquisition. In an asset acquisition, it is possible for an assembled workforce to be recognized as a separate asset.<sup>133</sup> However, as discussed in Section 1.D.3 of this book, the presence of an assembled workforce in an asset acquisition may mean that the transaction is actually not an asset acquisition but rather is a business combination.

<sup>129</sup>ASC 730-10-25-2(c).

<sup>130</sup>IAS 38, ¶ 34.

<sup>131</sup>IAS 38, ¶ 8. Section 1.B of this book more thoroughly discusses the definition of an intangible asset under IAS 38.

<sup>132</sup>ASC 805-20-55-6.

<sup>133</sup>ASC 350-30-25-4.

## 5. Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase

### a. Goodwill

Under both ASC 805 and IFRS 3, the excess of the fair value of the consideration transferred plus any noncontrolling interest in the acquiree over the acquisition-date fair value of the identified net assets acquired is considered goodwill.<sup>134</sup>

Worksheet 2 contains a comprehensive example of a business transaction in which goodwill is recognized. Worksheet 4 contains a disclosure from The Walt Disney Company concerning its 2012 acquisition of Marvel Entertainment. Worksheet 1 contains a comprehensive discussion of the nature and components of goodwill that explains the theoretical underpinnings and weaknesses behind the FASB's and IASB's definitions of goodwill.

### b. Bargain Purchase

If the consideration paid is less than the aggregate fair values of the identifiable assets, then the acquirer has made a bargain purchase. Former FAS 141 used the term *negative goodwill* and required an acquirer to pro-ratably reduce the amount allocated to certain assets to account for the negative goodwill. In contrast, currently, under ASC 805 and IFRS 3, any excess of consideration paid over the aggregate fair values of the identifiable assets is recognized as a gain on the acquisition date.<sup>135</sup> However, before recognizing a gain from a bargain purchase, the acquirer must reassess whether it correctly identified and measured all the identifiable assets and liabilities.<sup>136</sup> In reassessing its prior measurement of identifiable assets and liabilities, it must review the procedures it used to measure the following items:<sup>137</sup>

- a. The identifiable assets acquired and liabilities assumed
- b. The noncontrolling interest in the acquiree, if any

<sup>134</sup>ASC 805-30-30-1; IFRS 3, ¶ 32.

<sup>135</sup>ASC 805-30-25-2; ASC 805-30-30-4; IFRS 3, ¶ 34.

<sup>136</sup>ASC 805-30-25-4; ASC 805-30-30-5; IFRS 3, ¶ 36.

<sup>137</sup>ASC 805-30-30-5.

- c. For a business combination achieved in stages, the acquirer's previously held equity interest in the acquire
- d. The consideration transferred

Thus, the FASB has a two-step approach to recognizing a gain from a bargain purchase:

1. Reassess the identification and measurement of the acquiree's identifiable assets, liabilities, and contingent liabilities and the measurement of the cost of the combination. If there is any excess, go to step 2.
2. Recognize as a gain immediately in profit or loss any excess remaining after the reassessment in step 1.<sup>138</sup>

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<sup>138</sup>ASC 805-30-25-4 and IFRS 3, ¶¶ 34–36.

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