Discussion Paper

Initial Accounting for Internally Generated Intangible Assets

Authored by:
The Office of the Australian Accounting Standards Board

Foreword by:
The Chairman of the National Standard Setters

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Australian Government

Office of the Australian Accounting Standards Board

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ISBN 1 876884 13 4

FOREWORD FROM THE CHAIRMAN OF THE NATIONAL STANDARD SETTERS

The National Standard Setters (NSS) is a global group of representatives of national accounting standard-setters and related organisations whose main role is to assist the International Accounting Standards Board (IASB), primarily through research and commenting on project priorities. The publication of this Paper is consistent with the research role of the NSS. Various NSS members are also currently writing Papers on other research topics that are expected to be published in the future. Part of the NSS process is to encourage the IASB to take these topics onto its active agenda in due course.

This Paper has been authored by staff of the Australian Accounting Standards Board (AASB), with the encouragement and support of the NSS. Drafts of the Paper were provided to representatives of NSS members for comment, which assisted the authors in ensuring that the Paper addresses the relevant issues. A penultimate draft of the Paper was discussed at the September 2008 NSS meeting.

NSS member involvement in the development of this Paper does not necessarily indicate the agreement of NSS members, nor the organisations to which they belong, with the conclusions in the Paper. The level of NSS member involvement demonstrates their strong support for publication of the Paper as a means of facilitating international debate on the very important accounting issues addressed.

It is intended that this Paper be the first in a series of Papers relating to intangible assets that will be authored by individual NSS members as the research work continues. The IASB Chairman has encouraged the research work commenced by Australia to continue under the aegis of the NSS, with the IASB being involved through its usual representation, in the hope that some international agreement will emerge from that process.

I commend the AASB staff for their work in undertaking the research for and writing this Paper, and NSS representatives for their input. The NSS is of the

view that the Paper makes a significant contribution to the literature on accounting for intangible assets.

Ian Mackintosh
Chairman, National Standard Setters

List of NSS member organisations whose representatives were present at the March and/or September 2008 NSS meetings at which drafts of this Paper were considered

Standard setters from:
- Australia
- Canada
- France
- Germany
- Hong Kong
- India
- Italy
- Japan
- Lebanon
- Malaysia
- Mexico
- New Zealand
- Norway
- Republic of Korea
- Romania
- Saudi Arabia
- South Africa
- Sweden
- Taiwan
- Tunisia
- United Kingdom

European Financial Reporting Advisory Group
International Accounting Standards Board
International Public Sector Accounting Standards Board

REQUEST FOR COMMENTS

The purpose of this Paper is to encourage interested parties to think about issues concerning the initial accounting for internally generated intangible assets, and to comment on the views expressed, including the potential conceptual and practical implications of those views.

Comments on this Paper are requested by 15 May 2009 and can be emailed to either of the following:

> The NSS secretariat, at the United Kingdom Accounting Standards Board: asbcommentletters@frc-asb.org.uk
>
> Staff of the Australian Accounting Standards Board: standard@aasb.gov.au

Comments will be collated and provided as input to any future work that the IASB might initiate.

INTRODUCTORY COMMENTS AND ACKNOWLEDGEMENTS

On behalf of the International Accounting Standards Board (IASB), the Australian Accounting Standards Board (AASB) devoted considerable time and resources over the period 2004-2006 undertaking research on accounting for intangible assets. Since the 26 February 2006 Memorandum of Understanding between the IASB and the US Financial Accounting Standards Board (FASB), the IASB asked the AASB staff to shift the focus from research to drafting a project proposal for use in considering whether to add an intangible assets project to the IASB's and FASB's active agendas. That project proposal included an analysis of the following criteria used by the IASB and FASB to help assess the merits of initiating a project:

(a) Criterion 1: The relevance to users of the information involved and the reliability of information that could be provided;
(b) Criterion 2: Existing guidance available;
(c) Criterion 3: The possibility of increasing convergence; and
(d) Criterion 4: The quality of the standards to be developed.

The analysis of these criteria formed the basis of IASB Observer Notes that were made public in December 2007 (see http://www.iasb.org/NR/rdonlyres/73C77D51-E8DE-4BE7-9D8B-8668193F6BE0/0/AP0712b05aobs.pdf).

At their December 2007 meetings, the IASB and FASB considered the project proposal. They decided not to take the project on to their active agendas for the time being, primarily because both Boards currently have a number of other competing active agenda priorities. For example, the IASB decided, and we agree, that the need for guidance on accounting for emission rights and common control arrangements in business combinations is more urgent than the need for a new accounting model for intangible assets. Nevertheless, both Boards acknowledged the importance of addressing the accounting issues relating to intangible assets, including the inconsistent treatments for particular types of intangible assets depending upon the manner in which they arise.

Prior to focusing on the project proposal, our research reached the stage of considering in detail issues relating to the initial accounting for internally

generated intangible assets. We have since updated our work and combined it with some of the material that was included in the project proposal considered by the IASB and FASB. We think that this work is sufficiently advanced and self-contained for publication as this Discussion Paper. We hope that it provides a basis for international debate on the issues it identifies. We have attempted to take a relatively 'clean sheet' approach to the issues, and therefore we have not structured the Paper as a critical review of existing requirements in IAS 38 *Intangible Assets*. The project proposal presented to the IASB in December 2007 contains such a critical review. Also, the Accounting Standards Board of Japan has published a Paper *Case Study Analysis: Accounting Treatment of Internally Generated Development Costs Under IAS 38*, which is available at:

http://www.asb.or.jp/html_e/technical_topics_reports/development_costs_e.pdf

Given the history of the development of this Discussion Paper, there are many individuals and bodies we could acknowledge for their contributions. Unfortunately, they are too numerous to mention individually here. They include IASB staff and Board members, FASB staff and Board members, other AASB staff and Board members, individuals and organisations we interviewed for the purpose of this Paper, academics and representatives of members of the National Standard Setters (NSS). Representatives of members of the NSS were invited to comment on the penultimate draft of this Paper (September 2008) to help ensure that the Paper provides a reasonably comprehensive and balanced discussion of the issues. We considered each of the comments and, within our resource constraints, attempted to reflect as many of them as we could in the Paper. Any omissions or errors remain our responsibility.

We have written this Paper with a focus on arriving at conceptual views. We acknowledge that a more detailed cost-benefit analysis, including greater consideration of the practical implications of our conclusions, needs to be undertaken before our views are considered for implementation.

In acknowledging the work that is reflected in this Discussion Paper, the IASB Chairman has suggested that the research commenced by us continue under the aegis of the NSS, with the IASB being involved through its usual representation, in the hope that some international agreement will emerge from that process. In light of this encouragement, we hope that this Paper is the first of a series of Papers that considers the full range of issues that are pertinent to a comprehensive review of the accounting for intangible assets,

including the definition, initial and subsequent recognition, initial and subsequent measurement, presentation and disclosure of all types of intangible assets (whether acquired in a business combination, internally generated, or otherwise).

Although goodwill (whether acquired or internally generated) may be excluded from the scope of the project, we anticipate that any discussion of the definition of intangible assets would, of necessity, involve a comparison with the definition of goodwill. We would expect that consideration of the initial accounting for intangible assets acquired in a business combination would entail a post-implementation review of the requirements in IFRS 3 *Business Combinations* for identifying, recognising and measuring intangible assets acquired in a business combination, including an assessment of whether the approach satisfies user needs. We would also expect that consideration of the subsequent accounting issues would include consideration of impairment issues, implications for financial statement presentation (particularly in the context of the IASB's Financial Statement Presentation project) and cost/benefit analyses of alternative approaches.

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Dean Ardern
(Project Manager AASB, email: dardern@aasb.gov.au)

October 2008

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EXECUTIVE SUMMARY

<table>
<tr><th colspan="2">INITIAL ACCOUNTING FOR INTERNALLY GENERATED INTANGIBLE ASSETS</th></tr>
<tr><th colspan="2">Identification (Chapter 2)</th></tr>
<tr><td colspan="2">The manner by which an intangible item comes into existence is not relevant to the determination of whether the item can be identified as an asset. Therefore, intangible items of the same nature, irrespective of whether they are acquired in a business combination or internally generated (planned or unplanned), could be analysed in the same way for the purpose of determining whether they are assets. In particular, the principles and guidance for identifying the existence of and describing an intangible asset acquired in a business combination specified in IFRS 3 Business Combinations (and IAS 38 Intangible Assets) could be adopted for assessing whether internally generated intangible assets exist. Accordingly, a technique based on a hypothetical business combination is a possible technique for identifying internally generated intangible assets. (paragraph 66)</td></tr>
<tr><th colspan="2">Recognition (Chapter 3)</th></tr>
<tr><th>If a cost-based model were adopted</th><th>If a valuation-based model were adopted</th></tr>
<tr><td>Internally generated intangible assets that satisfy the definition of an intangible asset in IAS 38/IFRS 3 should be subject to the Framework's recognition criteria. Accordingly, only planned internally generated intangible assets should be contemplated for recognition, on the basis that the plan identifies the unit of account and it is only those types of internally generated intangible assets that could satisfy the reliable measurement (of cost) recognition criterion. They do not warrant more specific recognition criteria, although guidance on the meaning of a 'discrete plan that is being or has been implemented to create an internally generated intangible asset' would be helpful. (paragraph 87)</td><td>Internally generated intangible assets that satisfy the definition of an intangible asset in IAS 38/IFRS 3 should be subject to the same recognition requirements for intangible assets acquired in a business combination, using a technique based on a hypothetical business combination. Accordingly, all internally generated intangible assets that would be recognised if acquired in a business combination under IFRS 3 should be recognised. While less onerous identification techniques or recognition criteria could be adopted, they have significant conceptual shortcomings. (paragraph 113)</td></tr>
</table>

<table>
<tr><th colspan="2">Measurement (Chapter 4)</th></tr>
<tr><th>If a cost-based model were adopted</th><th>If a valuation-based model were adopted</th></tr>
<tr><td>It is reasonable to presume that historical cost can be reliably measured for planned internally generated intangible assets from the commencement of implementing the plan up until completion or abandonment of the plan, based on the principles in IASB standards for allocating costs to other types of assets. Therefore, the attributable costs of planned internally generated intangible assets should be required to be recognised (capitalised) as an asset. A transitional period may be warranted to allow entities time to develop adequate accounting systems.

Cost is not a suitable basis for measuring unplanned internally generated intangible assets because there is no basis for reliably attributing costs. (paragraph 134)</td><td>Internally generated intangible assets are capable of being reliably measured at fair value to the same degree that the IFRS 3 presumption (that the fair value of the same types of intangible assets acquired in a business combination is capable of reliable measurement) is valid. Subject to the outcome of the IASB/FASB Fair Value Measurement project, SFAS 157 Fair Value Measurements provides a possible basis for specifying the determination of fair value of internally generated intangible assets. Until then, IFRS 3 provides an adequate basis. (paragraph 171)</td></tr>
<tr><td colspan="2">From a technical conceptual perspective, internally generated intangible assets should be required to be initially measured at fair value to enhance the decision-usefulness of financial reports. An option to adopt cost as an alternative to fair value should not be allowed. On balance, we also think that this view can be justified on practical grounds. However, we acknowledge the views of some against our conclusion. Accordingly, before our conclusion is considered for implementation, we think that further investigation of the perceived practical impediments is warranted. (paragraph 190)</td></tr>
</table>

<table>
<tr><th colspan="2">Presentation/Disclosure (Chapter 5)</th></tr>
<tr><td colspan="2">The current reporting requirements in IAS 1 Presentation of Financial Statements can be applied to internally generated intangible assets, and are sufficient to facilitate the:
(a) separate presentation of internally generated intangible assets that are recognised; and
(b) disclosure of information in relation to the accounting policies adopted and judgements made by management in relation to internally generated intangible assets equivalent to the information that is required to be disclosed about other types of assets. (paragraph 203)</td></tr>
<tr><th>If a cost-based model were adopted</th><th>If a valuation-based model were adopted</th></tr>
<tr><td>The amount of costs incurred in a reporting period and recognised in the carrying amounts of internally generated intangible assets presented in the financial statements should be disclosed together with the accounting policies adopted. In response to users' comments, management's rationale for capitalisation should also be disclosed. (paragraph 214)</td><td>The methods and significant assumptions applied in determining an asset's fair value, including the extent to which the asset's fair value was determined directly by reference to observable prices or was estimated using other measurement techniques, should be disclosed. In addition, if changing one or more of the assumptions used to determine the fair value to reasonably possible alternative assumptions would change the fair value significantly, the entity should state this fact and disclose the effect of those changes. (paragraph 225)

In response to users' comments, the costs reliably attributable to an internally generated intangible asset should also be disclosed, either on an aggregate or a project-by-project basis. (paragraph 232)</td></tr>
<tr><td colspan="2">If an internally generated intangible asset does not meet the relevant recognition criteria, in the interests of providing useful information to users, entities should be required to disclose a description of the asset and the reason why the asset fails to meet the relevant recognition criteria. (paragraph 240)

Consistent with the recognition and disclosure principles in the Framework and IASB standards, disclosure is not an adequate substitute for recognition and internally generated intangible items that meet the relevant asset definition and recognition criteria should be recognised in the financial statements. While a disclosure-only approach may have some merit as a pragmatic interim step towards the adoption of a recognition-based accounting approach for internally generated intangible assets, in the interests of maximising the information content of financial statements on a timely basis, a recognition-based approach is preferred. (paragraph 258)</td></tr>
</table>

CHAPTER 1 – INTRODUCTION

BACKGROUND

1. The prevalence and order of magnitude of intangible assets are indicative of their importance from an external financial reporting perspective.

2. In relation to prevalence, intangible assets are found in a large number of entities across a range of industries and jurisdictions. Most businesses would be expected to have at least one type of intangible asset, such as customer lists, customer contracts and related customer relationships, non-contractual customer relationships, licence agreements and internally developed software. Examples of industries and their typical intangible assets that are integral to their operations include:

   (a) pharmaceutical companies (eg in-process research and development, and patents);

   (b) information technology companies, including web-based entities such as internet search engine developers and providers, and software development companies (eg computer software and website platforms);

   (c) media companies (eg publishing titles);

   (d) consumer product companies (eg brands and trademarks);

   (e) service-based companies (eg customer relationships, brands and trademarks); and

   (f) financial services companies (eg mortgage servicing rights and investment management rights).

3. In relation to their order of magnitude, because many intangible assets are not recognised in financial reports, we can only estimate their order of magnitude indirectly. For example, although research and development is not the only way in which intangible assets arise, and research and development efforts do not necessarily result in assets, various reports on economic activity indicate a significant level of research and development activities:

   (a) The National Science Foundation National Science Board reports that: "U.S. R&D expenditures have continued to rise steadily since 2002, reaching an estimated $340 billion in 2006" (page 5), and notes that the business sector's share of

U.S. R&D performance recovered to 71% in 2006 following the economic slowdown of 2001 and 2002 (page 5).[1] The report goes on to note that: "The U.S. R&D/GDP ratio was an estimated 2.57% in 2006 … (ranking) seventh among OECD countries" (page 6); and

(b) The Organisation for Economic Co-operation and Development (OECD) reports that OECD-wide expenditure on research and development reached $US 771.5 billion in 2005, or about 2.25% of overall GDP. It goes on to report that: "OECD-area R&D expenditure has increased steadily in recent years although more slowly than during the second half of the 1990s. Total gross expenditure on R&D grew by 4.6% annually (in real terms) between 1995 and 2001, but by less than 2.2% a year between 2001 and 2005."[2]

4. Market-to-book ratios (the ratio of market capitalisation to the carrying amount of net assets of an entity) are sometimes invoked as a measure of the significance of unrecognised intangible assets. In addition, the upward trend in mean market-to-book ratios is sometimes used as evidence of the 'new economy', characterised by the arrival of a new breed of more valuable unrecognised intangible assets.[3] Although stock prices relative to book values are an imperfect measure of the value attributed by investors to unrecognised intangible assets, the increase and increasing volatility in the mean market-to-book ratios since the mid-1980s identified by authors such as Lev (2001) and Beattie and Thomson (2005) arguably reflect: (1) intangible assets becoming an increasingly significant driver of corporate value; and/or (2) investors becoming increasingly aware of the role that intangible assets play with respect to corporate value.

5. Despite the significance of intangible assets to many reporting entities, existing International Accounting Standards Board (IASB) standards do not allow many of them to be recognised, depending on the manner in which they arise. In relation to today's environment, it has been observed by Upton that:

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1 National Science Foundation, National Science Board, (2008). 'Chapter 4: Research and Development: National Trends and International Linkages', *Science and Engineering Indicators 2008* (Volume 1), 15 January, pp. 5-6.

2 OECD, (2007). 'Chapter A-2 Trends in domestic R&D expenditure', *OECD Science, Technology and Industry Scoreboard 2007*, October (www.sourceoecd.org/scorecard).

3 See Lev, B. (2001). *Intangibles: Management, Measurement, and Reporting*, The Brookings Institution Press, Washington, D.C., p. 8; and Beattie, V. and Thomson, S.J. (2005). 'Intangibles and the OFR', *Financial Management*, June, pp. 29-30.

> The importance of intangible assets is the distinguishing feature of the new economy. By and large, existing financial statements recognise those assets only when they are acquired from others. Accounting standard-setters should develop a basis for the recognition and measurement of internally generated intangible assets. (page 59)[4]

THE OBJECTIVE OF THIS PAPER

6. Our objective is to encourage international debate about the issues discussed in this Paper. Within this Paper's limited scope, we challenge some of the requirements for internally generated intangible assets within existing IASB standards. We thereby ultimately hope to contribute to improvements in the IASB's standards on intangible assets.

THE SCOPE OF THIS PAPER

In: Internally Generated Intangible Assets

7. We address the initial accounting for internally generated intangible assets. This provides a clearly defined and self-contained focus for us. As we noted in the project proposal presented to the IASB in December 2007 (see http://www.iasb.org/NR/rdonlyres/73C77D51-E8DE-4BE7-9D8B-8668193F6BE0/0/AP0712b05aobs.pdf), consistent with our critical review of IAS 38 *Intangible Assets* reported in that project proposal, we think that considering changes to the existing requirements in IAS 38 for the initial accounting for internally generated intangible assets provides the greatest potential for improvements.

Out: Other Intangible Assets

8. We have excluded accounting for intangible assets acquired in a business combination from the scope of this Paper because it has been subject to relatively recent review as part of the IASB's Business Combinations Phases I and II projects. However, as noted in paragraph 27 below, in this Paper we consider the suitability of the current requirements for the initial accounting for intangible assets acquired in a business combination for the same kind of intangible assets that are internally generated.

9. Furthermore, we think that accounting for intangible assets that arise in other ways warrant relatively less attention than the accounting for internally generated intangible assets. This is mainly because the

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4 Upton, W. (2001). *Business and Financial Reporting, Challenges from the New Economy*, Financial Accounting Series, FASB, Norwalk, Connecticut.

treatments of tangible and intangible assets are generally consistent where the assets arise in the same way and therefore do not give rise to unique issues in the context of intangible assets. In particular:

(a) in relation to separately acquired intangible assets, including those acquired in exchange for a non-monetary asset or assets, the requirements in IAS 38 are relatively straightforward, typically give rise to the initial recognition and measurement of the intangible assets acquired, and are consistent with the requirements in IAS 16 *Property, Plant and Equipment* for separately acquired tangible assets within its scope;

(b) in relation to intangible assets acquired by way of a government grant:

    (i) the main issue arises from the requirements in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, and concerns the treatment of the credit side of the journal entry on initial recognition of a granted asset (whether tangible or intangible). IAS 20 allows the credit to be treated as either: (1) deferred income; or (2) a deduction in arriving at the carrying amount of the asset. Although this issue warrants consideration, we think that it would be more effectively addressed separately from intangible assets; and

    (ii) in relation to the debit side of the journal entry, IAS 20 allows a non-monetary asset acquired by way of a government grant to be initially measured at either: (1) fair value; or (2) a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use. Although we do not consider this issue explicitly in this Paper, we think that the issue could be considered in the light of our conclusions in this Paper; and

(c) in relation to intangible assets acquired in a group of assets or net assets that is not a business, paragraph 2(b) of IFRS 3 *Business Combinations* specifies requirements. Of particular note is that:

(i) many intangible assets, such as use rights (eg lease rights, mineral rights and exploration rights[5]), stem from ownership of an underlying tangible asset and are therefore acquired with the tangible asset. Paragraph IE16 accompanying IFRS 3 acknowledges that some identifiable intangible assets may have characteristics of assets other than intangible assets. It comments that those assets should be accounted for in accordance with their substance. This issue has unit of account implications that we address in paragraphs 36 and 37 of this Paper; and

(ii) the definition of a business in IFRS 3 limits the circumstances in which the acquisition of an integrated group of assets or net assets would not constitute a business. Paragraph BC41 of the Basis for Conclusions on Exposure Draft of Proposed Amendments to IFRS 3 (June 2005) noted the IASB view that, conceptually, acquisitions of all groups of assets should be accounted for in the same way to avoid the need to distinguish between groups of assets that are acquired in a business combination and those that are not. The IASB decided not to extend the scope of IFRS 3 to acquisitions of all asset groups because it noted that further research and deliberations of additional issues would be required, which would delay implementation of the revised standard's improvements to practice. We agree that, in due course, the requirements in paragraph 2(b) of IFRS 3 should be the subject of a separate review and we have not considered them further in this Paper.

Out: Goodwill

10. Our references to 'intangible assets' throughout this Paper are to identifiable intangible assets and therefore do not include goodwill. We do not think that it would be fruitful to pursue improvements in current requirements on accounting for goodwill at this stage because:

(a) in relation to internally generated goodwill, its non-recognition is firmly entrenched in accounting practice. Furthermore, paragraph OB16 of the IASB Exposure Draft *An Improved Conceptual Framework for Financial Reporting: Chapter 1 The Objective of Financial Reporting Chapter 2 Qualitative*

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5 The IASB is undertaking a separate Extractive Activities project and, therefore, issues relating to mineral rights and exploration rights are generally outside the scope of this Paper, even if they relate to internally generated intangible assets.

Characteristics and Constraints of Decision-useful Financial Reporting Information (referred to in this Paper as the IASB/FASB Exposure Draft on the Conceptual Framework [May 2008]) states "… financial reports are not designed to show the value of an entity"; and

(b) in relation to acquired goodwill, its treatment has been subject to relatively recent review as part of the IASB's Business Combinations Phases I and II projects.

In: Initial Accounting only

11. We acknowledge that subsequent accounting issues are an important aspect of accounting for intangible assets. They include measurement issues (which incorporate impairment issues) and presentation issues (particularly the manner in which any recognised changes in values of intangible assets should be presented in the statement of comprehensive income). However, we are focusing on initial rather than subsequent accounting, primarily to keep the scope of this Paper manageable. Accordingly, we need to distinguish between initial and subsequent accounting, particularly where an internally generated intangible asset is created over a period of time. To this end, for the purpose of this Paper, 'initial' accounting for an internally generated intangible asset commences at the start of, and occurs up to completion (or abandonment) of, its creation. This definition is consistent with treating any post-acquisition activities relating to, for example, an in-process research and development asset acquired in a business combination, as part of the initial accounting for the asset.

Out: Internally Generated Intangible Assets of Not-For-Profit Entities

12. Both private and public sector not-for-profit entities, for example research universities, may internally generate intangible assets. Depending on the nature of the solution to be developed for the shortcomings in current accounting requirements, the not-for-profit environment may give rise to additional issues relative to the for-profit environment. For example, measurement issues in a not-for-profit environment may be more complex because cash flows attributable to an internally generated intangible asset are more commonly absent. To keep the scope of this Paper manageable, we focus on internally generated intangible assets of for-profit entities.

In: The Definition of Intangible Assets in IAS 38/IFRS 3

13. The definition of 'intangible asset' contained in paragraph 8 of IAS 38, and recently adopted in revised IFRS 3 (January 2008), is "an identifiable non-monetary asset without physical substance." Some

argue that the distinction between tangible and intangible is increasingly irrelevant and the dividing line often arbitrary, for example, in relation to computer hardware and software, and composite assets (see paragraph 9(c)(i) of this Paper). However, for our purposes, we accept the distinction, given that it has been retained by the IASB in IFRS 3.

14. Some also argue that the principles in IFRS 3, including the definition of intangible assets, are inappropriate even for intangible assets acquired in a business combination, and that many intangible assets should not be separated from goodwill (a residual) in a business combination. However, because it reflects recent thinking of the IASB, we accept for the purpose of this Paper the existing requirements in IFRS 3, including the definition of intangible assets and the distinction it draws for the purposes of separating intangible assets from goodwill. Accordingly, we do not address intangible items that would not be identified as intangible assets in the context of a business combination under IFRS 3.

15. We acknowledge that an alternative approach would be to address the definition of an intangible asset from the IASB's *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*) perspective. Conceivably, that would encompass a broader range of intangible assets than IFRS 3, because IFRS 3 limits the range by specifying the identifiability criterion in the definition. For example, the identifiability criterion scopes out customer service capability, presence in geographic markets or locations, strong labour relations, ongoing training or recruiting programs, knowledge capital, ecological attitudes, outstanding credit ratings and access to capital markets, and favourable government relations (see, for example, paragraph B165 of SFAS 141 *Business Combinations*). However, IFRS 3 provides a more practical basis for our Paper. In our view, the advantages of our approach outweigh the disappointment to advocates of recognition of, or disclosure about, non-contractual, non-separable intangible assets.

16. As another alternative to our scope, instead of considering internally generated intangible assets as a group, we could separately focus on only one type of internally generated intangible asset. For example, we could focus on legally-based internally generated intangible assets (such as those that arise from signing a contract or being granted a statutory right) before considering non-legally-based internally generated intangible assets (such as those arising from non-contractual customer relationships) and explore the need for different recognition and measurement requirements. Alternatively, we could categorise internally generated intangible assets using the categories listed in the illustrative examples in IFRS 3 (reproduced in paragraph 33 of this

Paper) and contemplate introducing recognition requirements progressively over time, category by category. Some argue that such 'gradual recognition' may be more achievable than more radical changes to existing requirements. They note that the same recognition requirements for all internally generated intangible assets, being a wide and varied group of assets, may not be feasible. However, a risk of addressing small topics in isolation is that unwarranted differences in requirements would emerge for similar assets.

17. Our approach of adopting the definition of an intangible asset specified in IFRS 3 is consistent with excluding the initial accounting for intangible assets acquired in a business combination from our scope, and will help facilitate consistency in accounting across all types of intangible assets (as defined), irrespective of the manner in which they arise. Despite our approach, given current practice issues (see paragraph 102 of this Paper), we think that future research could include a post-implementation review of the initial accounting requirements for intangible assets prescribed in revised IFRS 3 and include consideration of whether identifiability is an appropriate basis for the distinction between intangible assets and goodwill, and confirm whether the approach in IFRS 3 satisfies user needs.

In: The Current Conceptual Framework, with some reference to the Emerging Conceptual Framework

18. With the exception of adopting the definition of intangible assets in IAS 38/IFRS 3, we address the other issues within the context of the existing *Framework*. The joint project between the IASB and the FASB to develop a common conceptual framework (the IASB/FASB Conceptual Framework project) is likely to result in changes to the *Framework*. Due to the uncertainty about the outcomes of that project, we mainly refer to the existing *Framework*.

19. In places, we refer to anticipated changes to the *Framework*. However, this is only done where it is apparent that the IASB has sufficiently developed its thinking, such as reflected in the IASB/FASB Exposure Draft on the Conceptual Framework (May 2008). Future research could include consideration of the implications of the revised *Framework* once it is finalised, compared with the existing *Framework*, on the accounting for internally generated intangible assets.

20. Paragraph 12 of the *Framework* states that:

> The objective of financial statements is to provide information about the financial position, performance and changes in financial position

of an entity that is useful to a wide range of users in making economic decisions.[6]

Paragraph 15 of the *Framework* notes that users are better able to evaluate the ability of an entity to generate cash and cash equivalents, including the timing and certainty of their generation, for the purposes of making economic decisions if they are provided with information that focuses on the financial position, performance and changes in financial position of an entity.[7] Paragraphs 24-42 of the *Framework* note that the four principal qualitative characteristics that make the information provided in financial reports useful to users are: understandability, relevance, reliability[8] and comparability. Paragraph 44 of the *Framework* notes that the balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic.

21. In developing our views on how internally generated intangible assets should be initially accounted for, we have regard to the objective of financial statements as described in the *Framework* and the consequential costs that may be imposed on preparers.

VIEWS OF PREPARERS AND USERS

22. We have formed our views in the context of the views expressed by a range of preparers and users of financial reports.

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6 This is broadly consistent with paragraph OB2 of the IASB/FASB Exposure Draft on the Conceptual Framework (May 2008), which states: "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Information that is decision-useful to capital providers may also be useful to other users of financial reporting who are not capital providers."

7 This is broadly consistent with paragraph OB15 of the IASB/FASB Exposure Draft on the Conceptual Framework (May 2008), which states: "Financial reporting should provide information about the economic resources of the entity (its assets) and the claims on those resources (its liabilities and equity). Financial reporting should also provide information about the effects of transactions and other events and circumstances that change an entity's economic resources and the claims to those resources. That information is useful to capital providers for assessing an entity's ability to generate net cash inflows and for assessing the effectiveness with which management has fulfilled its stewardship responsibilities."

8 The IASB/FASB Exposure Draft on the Conceptual Framework (May 2008) contemplates 'reliability' being replaced by 'faithful representation', to de-emphasise the focus on verifiability that has developed around the notion of reliability (see, for example, paragraphs BC2.12-BC2.17).

23. Some sophisticated users have consistently asked for the recognition of more intangible assets in addition to those acquired in a business combination. For example, in 1993 the Association for Investment Management and Research (AIMR)[9] (since renamed the CFA Institute) concluded that:

> … financial reporting can be modified so as at least to recognize more of the economic reality of intangible assets than it does now. (page 52)

More recently, inadequacies in the current requirements were noted by the CFA Institute:[10]

> Today, many companies in global markets are driven by the creation and use of intangible assets. Indeed, much of the major economic growth worldwide is attributable to such assets. The current reporting model is deficient in its requirements for transparent recognition and disclosure for intangibles. High priority should be given to improvements in the reporting of intangibles so that investors will have the information they need to understand, analyze, and value intangibles-dependent companies. (page 2)

24. In contrast, other sophisticated users express strong reservations about the recognition of intangible assets. These reservations were expressed, for example, at the Corporate Reporting Users Forum (CRUF) at the IASB in January 2007 (and more recently in a letter to the IASB, dated 1 August 2007[11]), at the Analysts Representative Group meeting at the IASB in February 2007, by a majority of PricewaterhouseCoopers (2007)[12] interviewees and some Canadian Users Advisory Committee (UAC) members.[13] Some of their reservations appear to be particularly related to the measurement basis that they expect might be adopted and concerns about the current measurement basis adopted for internally generated intangible assets and intangible assets acquired in a business combination.

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9 AIMR, (1993). *Financial Reporting in the 1990s and Beyond*, Charlottesville, Virginia.

10 CFA Institute, (2007). *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, July, Charlottesville, Virginia. Prepared by the CFA Institute Centre for Financial Market Integrity.

11 IASB and FASB, 2008. *Agenda Paper 5 – Appendix 2 (Observer Note): Corporate Reporting Users' Forum Briefing Pack*, Joint IASB/FASB Meeting, April, London.

12 In its survey of investor views, 'Measuring Assets and Liabilities: Investment Professionals' Views' (February 2007), PricewaterhouseCoopers met in late 2006 with over 50 buy-side and sell-side investment professionals in Boston, London, and New York, as well as a small number of investors based in San Francisco, Frankfurt, and Toronto to discuss their use of the balance sheet in their analysis of performance.

13 In response to a series of questions about various aspects of accounting for intangible assets, we received written responses from 11 members of the Canadian UAC. These include a lender, a regulator, investors, a buy-side analyst, and venture capitalists.

25. In addition to identifying these views, we conducted interviews with a limited number of individuals (fourteen, of whom two could be categorised as users/analysts) within Australian organisations with experience in identifying, recognising and measuring internally generated intangible assets and using the resulting information. The main reason for selecting Australian organisations was that, prior to the adoption of IFRSs, Australian Accounting Standards permitted or required internally generated intangible assets to be recognised and measured in a broader range of circumstances than under IAS 38. Given the small number interviewed and their geographic concentration, it may not be appropriate to generalise from the findings. However, where relevant throughout this Paper, we reflect on the comments made by the interviewees to add a pragmatic perspective to our conclusions. Depending on the nature of the comments made by interviewees, they are presented either before or after the conclusions expressed in each Chapter and not necessarily in a separate section. Appendix A provides further details about the interviews and interviewees.

26. Appendix B provides a summary of our survey of academic research that investigated matters relating to the recognition of intangible assets and its implications for users.

THE STRUCTURE OF THIS PAPER

27. As noted in paragraph 8, although we do not address the initial accounting for intangible assets acquired in a business combination in this Paper, we consider whether the principles adopted for the initial accounting for intangible assets acquired in a business combination could and should be adopted for the same kind of intangible assets that are internally generated. We also consider whether, as an alternative, the principles adopted for the initial accounting for internally generated tangible assets (in particular, those in IAS 16) could and should be adopted for internally generated intangible assets.

28. Consistent with a common way of analysing accounting issues, while acknowledging the interrelationships between the various aspects (which creates some repetition in our analysis), we first analyse definition/identification issues [Chapter 2], then recognition issues [Chapter 3], followed by measurement issues [Chapter 4]. We conclude with a chapter on presentation/disclosure issues [Chapter 5].

CHAPTER 2 – DEFINITION/IDENTIFICATION

INTRODUCTION

29. In this Chapter we consider the main issues relating to the initial identification of internally generated intangible assets in the context of the definitions of an asset and an intangible asset specified in the *Framework* and IAS 38/IFRS 3 respectively.

DEFINITIONS

30. Paragraph 49(a) of the *Framework* defines an asset as:

> a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

31. It is apparent from this definition that an asset may be intangible.[14] This is consistent with the fact that there is a definition of an intangible asset in paragraph 8 of IAS 38 (and repeated in Appendix A of IFRS 3):

> An intangible asset is an identifiable non-monetary asset without physical substance.

32. In explaining the meaning of 'identifiable', paragraph 12 of IAS 38 (as amended in January 2008 as a consequence of revisions to IFRS 3) states that:

> An asset is identifiable if it either:
>
> (a) is separable, ie 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; or

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14 Indications to date are that the definition of an asset being developed under the IASB/FASB Conceptual Framework project also encompasses an intangible asset that is internally generated. See, for instance, the observer notes for agenda paper 4A to the 22 October 2007 IASB-FASB meeting "Conceptual Framework, Phase B: Elements & Recognition" and for agenda paper 16B to the 16 October 2007 IASB meeting "Conceptual Framework, Phase B: Elements and Recognition – Asset Definition Examples".

(b) 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.

33. IFRS 3 is accompanied by illustrative examples of items acquired in business combinations that meet the definition of an intangible asset (paragraphs IE16-IE44). The examples are not exhaustive and do not form part of IFRS 3. However, they are instructive and notably broader than the types of intangible assets explicitly contemplated prior to the original issue of IFRS 3 in March 2004. The examples are classified under the following five headings:[15]

A Marketing-related intangible assets (eg trademarks #, trade names #, newspaper mastheads #, internet domain names #);

B Customer-related intangible assets (eg customer lists *, order or production backlog #, customer contracts and the related customer relationships #, non-contractual customer relationships *);

C Artistic-related intangible assets (eg plays #, literary works #, television programmes #);

D Contract-based intangible assets (eg licensing agreements #, operating and broadcast rights #, lease agreements #); and

E Technology-based intangible assets (eg patented technology #, computer software #, unpatented technology *, databases *, trade secrets #).

34. Even an intangible item that an entity does not intend to use, but holds in order to deny other entities access to it, may satisfy the definition of an intangible asset. Paragraph B43 of IFRS 3 (and paragraph A12 of SFAS 157 *Fair Value Measurements* [September 2006]) explicitly addresses this circumstance and concludes that an asset exists (with not necessarily a value of zero). Accordingly, protection of a revenue stream from competition, for example, is an asset.

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15 In the Illustrative Examples that accompany IFRS 3, the IASB distinguishes intangible assets that arise from contractual or other legal rights (whether separable or not) and we have designated them with the symbol #, from intangible assets that do not arise from contractual or other legal rights but are separable and we have designated them with the symbol *.

Descriptors/Units of Account for Individual Internally Generated Intangible Assets

35. In considering whether a particular internally generated intangible item satisfies the definition of an asset and an intangible asset, it is necessary to circumscribe the item, and use a descriptor that depicts the item's economic phenomenon. This then identifies the unit of account. For some internally generated intangible assets, the unit of account may be evident from an entity's discrete plan to create the asset, having regard to the principles in paragraphs 36 and 37 below. There may even be an interim unit of account in the nature of an in-process asset until the ultimate unit of account is identifiable following completion or abandonment of the discrete plan. For other internally generated intangible assets, in the absence of a discrete plan, the unit of account may still be determined having regard to the principles in paragraphs 36 and 37 below. (Whether the distinction between internally generated intangible assets created under a discrete plan and those not created under a discrete plan is a useful basis for categorising internally generated intangible assets is considered in paragraph 41 and succeeding paragraphs.)

36. Assets that have descriptions implying that they are tangible assets, such as land, may include an intangible component. For example, the (intangible) view from a block of land is inextricably linked to the land and in practice it is not separated nor typically explicitly acknowledged for financial reporting purposes. On the other hand, other intangible attributes of land may be separately identified, such as 'development rights' granted by a Council on the land, or 'specific use rights' granted for a building (eg to operate a casino). It is generally understood that the descriptor 'land' may include some non-physical attributes such as the view from the land. The descriptor conveys the nature of the asset (eg land), and measurement incorporates possible additional attributes (eg coastal view).

37. Similar to land, the descriptor ascribed to a particular internally generated intangible asset should be meaningful in its commonly understood way, even though it may include a range of inextricably linked intangible (and possibly some insubstantial tangible) attributes. Examples of this specifically related to intangible assets are noted in paragraphs 36 and 37 of IAS 38.[16] One example provided in IAS 38 is that the descriptor 'brand' may comprise a group of complementary assets such as a trademark and its related trade name, formulas, recipes and technological expertise. The description that is

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16 The IASB is proposing to amend paragraphs 36 and 37 of IAS 38 through *Annual Improvements to IFRSs – Exposure Draft August 2008*. However, the proposed amendments do not fundamentally change the effect of the paragraphs.

appropriate to be adopted for an item can only be considered on an item-by-item/asset-by-asset basis having regard to the prevailing facts and circumstances, because of, for example, the different ways in which entities internally generate intangible assets and the different objectives they aim to achieve. We consider issues relating to descriptors suitable for internally generated intangible assets further in Chapter 5 of this Paper.

Identification of Internally Generated Intangible Assets

38. The definitions of an asset and an intangible asset, including the notion of identifiability, prescribed by IFRS 3 and the descriptors adopted for a particular asset do not distinguish between the manner in which the asset is acquired. Therefore, irrespective of the manner in which an intangible item arises, conceptually it satisfies the definition of an asset if it is a resource controlled by the entity as a result of a past event and from which future economic benefits are expected to flow.

39. Upton (2001) states:

> Is there any rationale, based on the definition of an asset, why … items are assets when acquired in a business combination or other purchase and not assets when created internally?
>
> No. Genealogy is not an essential characteristic of an asset. If an item satisfies the definition of an asset, it matters not how the entity came to control the asset. A transaction with another entity – a purchase of individual items or a business combination – provides evidence that an asset may exist. However, it is not the only way that an entity can acquire or create assets. If it were, self-constructed tangible assets would never qualify for recognition. (page 70)

40. Although the manner by which an intangible item arises is not a determinant of whether it meets the definition of an asset, we need to determine which event would prompt its identification as an asset. A transaction that involves the incurrence of costs (even other than costs incurred in a business combination) may provide evidence of a past event as justification for identifying the existence of an intangible asset. However, it is not necessary for costs to be incurred in generating an asset. Furthermore, even where costs are incurred, it is not necessary to be able to attribute those costs to an asset to justify an asset's existence. The *Framework* also makes it clear that the incurrence of costs does not necessarily imply the creation of an asset. Paragraph 59 of the *Framework* states:

> There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained.

41. To help determine the event that would justify identification of an internally generated intangible asset, it is useful to consider the different ways in which such assets may arise. For discussion purposes we distinguish two broad types of internally generated intangible assets:

    (a) 'planned internally generated intangible assets', being those created out of a discrete plan, the primary purpose of which is to create the assets; and

    (b) 'unplanned internally generated intangible assets', being other internally generated intangible assets that arise from the day-to-day operations of a business.[17]

42. In Appendix C to this Paper we provide an analysis supporting the view that both planned and unplanned internally generated intangible items might satisfy the definition of an asset.

43. The distinction between planned and unplanned internally generated intangible assets is effectively determined by the foresight of management and the manner in which management organises its intangible asset generating activities and, therefore, arguably places undue emphasis on procedure/process. Many internally generated intangible assets arise from 'unplanned' events or serendipity. Indeed, many organisations deliberately foster unstructured environments to enhance creativity. Therefore, a planned/unplanned basis for distinguishing different types of internally generated intangible assets may be of concern if the two categories are to be subject to different accounting requirements.

44. Furthermore, the identification of a planned internally generated intangible asset would be associated with the incurrence of costs reliably attributable to the asset from inception of the plan. Some may be particularly concerned by the identification of assets and their treatment being determined by the quality of the cost attribution

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17 These categories, although expressed slightly differently, are also identified by Upton (2001). In addition, Upton identifies a third category – those that exist only by virtue of their relation to some other asset or liability, such as value of insurance-in-force. For the purposes of this Paper, we subsume this category into the unplanned internally generated intangible assets category. (page 70)

accounting system. Planning is a forward-looking exercise whereas cost measurement is essentially a backward looking exercise. Some argue that planning may make cost determination easier, but it does not necessarily follow that the lack of planning would preclude a reliable cost determination, although cost accumulation may commence earlier when there is a plan.

45. If it were to be decided that planned and unplanned intangible assets should be subject to different accounting requirements, it would be particularly important to ensure that the distinction between the two categories is clear. In discussing the two categories separately in this Chapter, we do not intend to pre-empt the question of whether they should be treated differently for accounting purposes. We address that question later in this Paper.

Planned Internally Generated Intangible Assets

46. Planned internally generated intangible assets include the types of intangible assets that IAS 38 contemplates as arising from a research phase or development phase of an internal project. However, the nature of planned internally generated intangible assets is broader than research and development, and such assets may arise earlier than when IAS 38 contemplates them being recognised. For example, there might be a discrete plan to develop a brand for which costs can be reliably attributed as the plan is implemented. Compared with research and development projects, it may be more difficult to identify when a brand moves from its work-in-process phase to its completed phase, but in concept the same principles could apply. Some argue, for example, that a brand should be recognised as having moved out of its work-in-process phase when it has been announced to the intended market.

Even a failed plan can give rise to an asset

47. A fully implemented discrete plan, and even an abandoned plan, may yield knowledge that, if kept secret, satisfies the definition of an asset. For the purpose of this Paper, a successfully implemented plan means that the gross future economic benefits expected to be derived from, for example, new knowledge exceed the costs of acquiring the knowledge. Unsuccessfully implemented plans include those that, although they are expected to provide gross future economic benefits, the benefits are not expected to exceed the attributable costs. Pursuing a line of enquiry only to find that it is a 'dead-end' provides knowledge that it is a dead-end, which might be of some benefit even though the foreseeable gross benefits do not exceed the cost of acquiring the knowledge.

An interim asset might exist

48. A question arises as to whether knowledge must have been acquired (that is, whether a plan's success or failure must be known) before an asset is identified or whether it is appropriate to identify an asset (an in-process asset) in the process of, for example, pursuing knowledge that is to be kept secret (a finished asset). The nature of in-process research and development, for example, implies that success or failure may not yet be known. Despite this, IFRS 3 anticipates in-process research and development being identified as an asset acquired in a business combination. Consistent with this, an item that arises during the process of developing an internally generated intangible asset under a discrete plan is capable of being an (interim) asset in its own right. This is consistent with extractive activities accounting under the 'area of interest' approach,[18] which provides a basis for/unit of account for accumulating costs that comprise an asset as exploration takes place. In contrast, IAS 38 contemplates the recognition of an internally generated intangible asset when, and only when, it arises from development activity and its technical and commercial feasibility of completion can be demonstrated by the entity. We discuss this matter further in Chapter 3 of this Paper in the context of recognition.

Even if plans change, assets may continue to exist

49. The dynamic nature of many discrete plans means that original plans may be modified. This may cause the subject asset or assets to change. If, for example, an original plan is subsequently divided into two separate projects (assets), an issue may arise as to how to allocate previously incurred costs to the separate assets. This is a one-to-many problem not unique to intangible assets and therefore does not present unique or insurmountable problems, and is more pertinent to the initial measurement issue rather than the initial identification issue.

Unplanned Internally Generated Intangible Assets

50. Although unplanned internally generated intangible assets may have observable activities associated with them, they differ from planned internally generated intangible assets in that the observable activities are not undertaken in accordance with a discrete plan. Even if costs are incurred in relation to those activities, we contend that those costs would not be reliably attributable to the asset early enough to faithfully represent the full cost of the asset due to the absence of a discrete plan. Examples are internally generated brands, mastheads, publishing titles and customer lists that have not been, or are not

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18 The 'area of interest' approach is prescribed in Australian Accounting Standard AASB 6 *Exploration for and Evaluation of Mineral Resources*.

being, created out of discrete plans. Under the current requirements in IAS 38 such assets are acknowledged as being assets but are not permitted to be recognised. For example, paragraph 63 of IAS 38 states:

> Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

51. There may not be a specific event that causes an entity to become aware that an identifiable internally generated intangible asset exists. Therefore, it may be necessary at each reporting date to search for unplanned internally generated intangible assets that may have emerged since the previous reporting date. This issue is related to the issue of recognition as it would be onerous if an accounting standard-setter were to require an entity to identify internally generated intangible assets if the standard-setter does not intend that they be recognised. However, for the purpose of this Chapter, in the following we consider a technique for identifying an entity's internally generated intangible assets (both planned and unplanned) without regard to recognition consequences. In Chapter 3 we then consider the technique in the context of recognition.

A Technique for Identifying Internally Generated Intangible Assets

52. Identification of all of the intangible assets as defined in IAS 38/IFRS 3 within an entity could be achieved through a technique based on a hypothetical business combination, whereby the entity is assumed to be an acquiree as at the reporting date. This 'top-down' approach is a mechanism for facilitating the identification of assets of an entity from an holistic perspective. A more piecemeal 'bottom-up' approach to identifying assets runs the risk of overlooking some assets.

53. As reported in an article by Britton Manasco,[19] Dow Chemical undertook an exercise for internal management purposes that included the identification of 'patents' and was planning to undertake a similar exercise for 'know-how'. It is apparent from the work of Gordon Pretash and his team at Dow Chemical that the exercise was demanding but provided valuable information. Similarly, an exercise undertaken to identify intangible assets acquired in a business combination for external financial reporting purposes would be demanding but would arguably provide valuable information. Presumably the exercise of an entity identifying its own internally generated intangible assets would be less demanding than the exercise

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19 (1997). 'Dow Chemical Capitalizes on Intellectual Assets', *Knowledge Inc*, March.

of an entity identifying the intangible assets of a potential subsidiary, as we note in the following paragraph.

54. There are different circumstances in each business combination. In a 'friendly' business combination a thorough due diligence is typically possible. In a 'hostile' business combination, there may be very little opportunity for due diligence. Presumably an entity knows more about its existing internally generated intangible assets (irrespective of the manner in which they have been generated) than the intangible assets it acquires in a business combination, particularly compared with a hostile business combination, because it has been involved in their creation.

55. A technique based on a hypothetical business combination has similarities with aspects of step two of the two-step approach for impairment testing goodwill that was proposed as part of Phase I of the IASB Business Combinations project (ED 3 *Business Combinations*, published in December 2002 together with Exposure Draft of Proposed Amendments to IAS 36, *Impairment of Assets*, and IAS 38, *Intangible Assets*). That step involved the determination of the implied value of goodwill, which in turn was effectively determined using a hypothetical business combination technique. The proposed technique included some relief from the detailed calculations that might otherwise be required, by accepting for impairment testing purposes the most recent detailed calculation made in a preceding reporting period of the recoverable amount of a cash-generating unit to which goodwill has been allocated for that unit in the current period, provided specified criteria are met (see paragraph 96 of the Exposure Draft of Proposed Amendments to IAS 36, *Impairment of Assets*, and IAS 38, *Intangible Assets*). As indicated in paragraphs BC165-BC170 accompanying IAS 36, the IASB rejected the approach for the purpose of impairment testing goodwill for a number of reasons, including on cost-benefit grounds. Arguably, if the technique were to be used for identification of internally generated intangible assets, the benefits would exceed those that would be derived from the technique if it were to be used only for the purpose of impairment testing goodwill.

56. We acknowledge that applying a technique based on a hypothetical business combination may be difficult and costly the first time it is adopted. However, it would presumably provide information useful for management and we expect that, once a system for identifying internally generated intangible assets is in place, the ongoing costs and efforts would be significantly less than the initial costs and efforts. Furthermore, if standard-setters decide not to require the recognition of all internally generated intangible assets, it may be possible to find less onerous techniques for identifying fewer assets, effectively using

the identification process as a more practical recognition filter. We consider these alternative techniques in the context of recognition in Chapter 3.

57. For the purpose of this Chapter, it is sufficient to note that a technique based on a hypothetical business combination could be adopted for the purposes of initially identifying internally generated intangible assets. We consider whether it could and should be extended to provide a context for the initial recognition and measurement of the assets in Chapters 3 and 4 respectively.

INTERVIEWEES' PERSPECTIVES

58. By virtue of their roles as accountants, auditors and professional advisors, those from large accounting firms who we interviewed for the purpose of this Paper noted their experiences in identifying a broad range of internally generated intangible assets. The main categories of internally generated intangible assets encountered prior to the introduction of IAS 38/IFRS 3 in Australia by those from large accounting firms interviewed included brand names and related trademarks, mastheads, patents, customer relations and client lists, distribution/franchising agreements, management rights and research and development. A number of interviewees also mentioned 'intellectual property', which can be regarded to some extent as an umbrella term for a range of intangible assets.

59. The financial report preparers interviewed from consumer product corporations identified internally generated brand names and associated intangible assets, including distribution/franchising agreements and customer mailing lists as the main types of internally generated intangible assets about which they had experience. These preparers also noted a number of other types of internally generated intangible assets their corporations had identified (and recognised) prior to the introduction of IAS 38/IFRS 3, including software development costs, intellectual property and marketing and advertising costs.

60. Those interviewed from financial services corporations indicated that they had not normally identified (and recognised) internally generated intangible assets, particularly with respect to the banking side of their businesses, mainly due to the requirements imposed upon them by prudential regulations.[20] Nevertheless, those from financial services

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20 In specifying prudential capital ratios for Authorised Deposit-taking Institutions (ADIs) in Australia, the Australian Prudential Regulation Authority (APRA) currently excludes intangible assets, such as capitalised expenditures and purchased goodwill, from capital. This treatment is equivalent to expensing these items to the ADI's profit or loss for the

corporations noted that on occasions they had capitalised software development costs, but only when the cost of the specific project exceeded a pre-determined monetary or materiality threshold. One of those from a financial services corporation also noted that the carrying value of its life insurance liabilities incorporated a value for margins related to in-force business, including the value of new business from its existing client base. One of those from a telecommunication and broadcasting corporation noted that the main category of internally generated intangible asset it had identified (and recognised) in the past was software development costs. The other telecommunication and broadcasting corporation advised that in the past it had generally resisted identifying (and recognising) internally generated intangible assets. Being politically visible and price regulated, the corporation indicated that the identification (and recognition) of additional assets in the form of internally generated intangible assets on the entity's balance sheet could give rise to 'write-down' risk in the future.

61. All of the large accounting firms interviewed by us noted that the presence of economic benefits that could be directly attributed to an intangible item is critical to its identification as an asset.[21] In many cases, identifiable separable cash flows directly attributable to an intangible item are regarded as sufficient to indicate the existence of economic benefits. However, other factors are also regarded as persuasive. For instance, if the economic benefits attributable to an intangible asset are not separately identifiable from the benefits generated by the larger business unit to which the internally generated intangible asset belongs (a cash generating unit/unit of account issue), but it is reasonable to assume that the productivity of the business unit would be diminished by removing the intangible asset, this is sufficient to indicate the existence of economic benefits. Other factors identified by interviewees as suggesting the existence of an intangible asset include the presence of contractual or other legal rights or the likely prospect of being able to sell the intangible asset to an unrelated third party.

62. Like those from large accounting firms, the preparers from consumer product corporations indicated that the presence of economic benefits directly attributable to an internally generated intangible item is critical to its identification as an asset. Consistent with their

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period (see APRA Prudential Standard APS 111 *Capital Adequacy: Measurement of Capital* (January 2008)).

21 Consistent with recent decisions of the IASB (for example, in relation to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* redeliberations relating to the phrase 'expected to' in the definition of a liability), the presence of expected future cash flows as the basis for the existence of an asset is not essential. Rather it is the present right that is the essence of an asset, not the expectation of future economic benefits.

marketing focus, those from consumer product corporations emphasised the role intangible assets play in their operations in generating earnings. In particular, those from consumer product corporations noted the capacity of brand names to provide assurance to their owners of demand for the related products, indicated by a positive relationship between marketing expenditure and product demand. Those from consumer product corporations also noted that the existence of a positive deprival or resale value for an internally generated intangible item is taken to indicate the presence of future economic benefits.

63. Other comments from interviewees addressed the control aspect of the definition of an asset. In particular, interviewees from large accounting firms and the three from consumer product corporations indicated that, consistent with the notion of identifiability in IAS 38, legal control in the form of a registered trademark or contract is sufficient to suggest that future economic benefits are likely to flow to the entity and therefore that an asset exists.

64. Of the interviewees who indicated that their corporations identified (and recognised) internally generated software as an intangible asset prior to the introduction of IAS 38,[22] as noted in paragraph 60 above, some confirmed that they had capitalised software development expenditures once they exceeded a pre-determined dollar or materiality threshold. Moreover, all of the entities that indicated they capitalised software development expenditures confirmed that they incurred the expenditures for the purpose of developing software for internal administrative purposes. This appears to be consistent with, for example, AICPA AcSEC SOP 98-1 *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (March 1998).

65. The comments in paragraphs 63 and 64 above suggest that, in the absence of legal control, the future economic benefits associated with an internally generated intangible asset are arguably more likely to be controlled by an entity when the asset is created out of a discrete plan and is expected to provide benefits to the entity in the form of decreased outflows (as opposed to increased inflows) of economic benefits in the future. While an entity might be able to exclude competitors from capturing some or all of the benefits associated with improved administration systems by maintaining secrecy around its development, the same is less likely to be the case for design, construction and assembly improvements in products sold in the marketplace.

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22 These are both of the financial services corporations, one of the consumer product corporations and one of the telecommunication and broadcasting corporations.

CONCLUSION

66. *We conclude that the manner by which an intangible item comes into existence is not relevant to the determination of whether the item can be identified as an asset. Therefore, intangible items of the same nature, irrespective of whether they are acquired in a business combination or internally generated (planned or unplanned), could be analysed in the same way for the purpose of determining whether they are assets. In particular, the principles and guidance for identifying the existence of and describing an intangible asset acquired in a business combination specified in IFRS 3 (and IAS 38) could be adopted for assessing whether internally generated intangible assets exist. Accordingly, a technique based on a hypothetical business combination is a possible technique for identifying internally generated intangible assets.*

Implications for Current Requirements

67. This conclusion is consistent with IAS 38 because IAS 38 adopts the definitions of an asset and intangible asset consistent with IFRS 3, even for internally generated intangible assets. However, IAS 38 has limited guidance on the identification of internally generated intangible assets. If our view in paragraph 66 of this Paper is adopted, the current guidance for identifying intangible assets acquired in a business combination in IAS 38/IFRS 3 could be adopted for the identification of internally generated intangible assets.

CHAPTER 3 – RECOGNITION

INTRODUCTION

68. IAS 38 prohibits recognition of internally generated intangible assets arising from 'research' and, as noted in paragraph 50 above, 'brands, mastheads, publishing titles, customer lists and items similar in substance', and requires the recognition of internally generated intangible assets arising from 'development' only in certain circumstances.

69. In contrast, paragraph 83 of the *Framework* states:

> An item that meets the definition of an element should be recognised if:
>
> (a) it is probable that any future economic benefit associated with the item will flow to … the enterprise; and
>
> (b) the item has a cost or value that can be measured with reliability.

70. In this Chapter, we consider the suitability of adopting the *Framework* or IFRS 3 recognition criteria for internally generated intangible assets. Because the *Framework* does not express a preference for cost or value, it is useful to consider the recognition criteria in the context of both a cost-based model and a valuation-based model.

71. For our purposes:

    (a) a cost-based model is one in which the emphasis is on accounting for the consequences of costs (that is, historical cost) incurred by the entity; and

    (b) a valuation-based model is one in which the emphasis is on accounting for current value (and changes in value), irrespective of whether that value arises from an attributable cost. Although the *Framework* does not specify the value measurement attribute, given the adoption of fair value in a number of recent IASB standards and its prominence in a range of current IASB projects, we focus on fair value. However, in light of the IASB's ongoing Fair Value Measurement project, we limit the extent to which we delve into the detail of fair value.

    Consistent with the *Framework*, we do not express a preference for the measurement model to be adopted in the context of the recognition

criteria. However, we express a preference from a measurement perspective in Chapter 4.

72. It is relevant to consider both models for internally generated intangible assets because:

    (a) paragraph 21(b) of IAS 38 relating to the initial recognition of internally generated intangible assets only refers to cost (as does IAS 16 in relation to initial recognition of internally generated property, plant and equipment) and is therefore consistent with a cost-based model; and

    (b) paragraph 18 of IFRS 3 relating to the initial recognition of intangible assets acquired in a business combination only refers to fair value and is therefore consistent with a valuation-based model, as we discuss in paragraphs 73 and 74 below.

73. The cost to the acquirer of a particular asset acquired in a business combination is not directly available. Accordingly, IFRS 3 does not contemplate cost as such as a measurement basis in specifying recognition criteria. However, paragraph 33 of IAS 38 states that, if an intangible asset is acquired in a business combination, the 'cost' of that intangible asset is its fair value at the acquisition date. Therefore, some argue, paragraph 33 of IAS 38 implies that the IASB's measurement preference is cost over fair value, and fair value is only used in the absence of cost and as an expedient way of accounting for the transaction. This is reinforced in paragraph BC43 accompanying IFRS 3, which states that "Requiring use of the acquisition method is not a step towards adopting a fair value accounting model."

74. In contrast, others argue that IFRS 3 requirements relating to, for example, a bargain purchase, mean that the fair value of intangible assets acquired in a business combination is not perceived to be a surrogate for cost, but is fair value in its own right. Although some still regard IFRS 3's requirement to recognise intangible assets in a business combination as part of the process of allocating the cost of the business combination, in fact IFRS 3 requirements mean that the cost does not provide a cap for the purposes of allocation – it merely provides a 'reality check'. Paragraph 34 of IFRS 3 contemplates that the net fair value of the identifiable assets (including intangible assets), liabilities and contingent liabilities recognised in a business combination may occasionally exceed the cost of the business combination. If this situation arises, IFRS 3 requires a reassessment of any excess to confirm that the excess is valid and the recognition of any remaining excess immediately in profit or loss. Because the IFRS 3 principles for recognising intangible assets acquired in a business combination are not limited by the cost of the business

combination, conceptually they could be applied for the purpose of recognising internally generated intangible assets without being constrained by a cost notion.

APPLYING THE FRAMEWORK RECOGNITION CRITERIA UNDER A COST-BASED MODEL

75. Under a cost-based model, the *Framework* recognition criteria would result in costs attributable to an internally generated intangible asset being initially capitalised (albeit susceptible to an impairment write down).

76. Where the asset recognition criteria are not met, all costs attributed to the activity giving rise to the asset would be immediately expensed, and no asset would be recognised. We consider whether or not an internally generated intangible asset that fails the relevant asset recognition criteria should be subject to disclosure requirements in Chapter 5.

Probable Future Economic Benefits[23]

77. Under a cost-based model, the recognition of capitalised costs associated with an internally generated intangible asset would only be justified where future economic benefits are probable. This would be the case for successfully implemented and finalised discrete plans to develop internally generated intangible assets.

78. It may also be that future economic benefits are probable for in-process and even unsuccessfully implemented plans (see paragraph 47 of this Paper), because the phrase 'probable future economic benefits' does not necessarily mean 'probable positive net future economic benefits'. In particular, it is conceivable that the recognition criterion could be met even where negative net future economic benefits are probable – so long as positive gross future economic benefits are probable. Circumstances where gross outflows (attributable costs) exceed gross inflows would be addressed through measurement/impairment rather than through recognition (or definition).

Reliable Measurement

79. Under a cost-based model, internally generated intangible assets would be initially recognised at cost where cost is reliably measurable.

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23 Given the direction of the IASB/FASB Conceptual Framework project, the 'probable future economic benefits' recognition criterion may be removed from the *Framework*. We discuss it in this Paper on the assumption that it continues to exist.

We discuss whether the cost of internally generated intangible assets can be reliably measured in Chapter 4.

Are the Framework Recognition Criteria preferable to the IAS 38 Recognition Criteria for Internally Generated Intangible Assets?

80. Some argue that adoption of the *Framework* asset recognition criteria under a cost-based model would result in the recognition of too many internally generated intangible assets. They believe that the current, more restrictive, recognition criteria in IAS 38 are appropriate. Paragraph 51 of IAS 38 provides the following rationale for its approach:

> It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in:
>
> (a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and
>
> (b) determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations …

Some even argue that the IAS 38 criteria should be more restrictive.

81. Research costs are generally expensed as incurred under current IASB and national requirements. This is consistent with the view held by some that research costs, by their nature, are too remote from their ultimate potential outcome to be regarded as costs that give rise to an asset.

82. Some jurisdictions (Germany, Japan and the US) also require development costs to be expensed as incurred. The Basis for Conclusions accompanying SFAS 2 *Accounting for Research and Development Costs* (October 1974) identifies a number of reasons for expensing development (and research) costs. The reasons include uncertainty of future benefits, a lack of causal relationship between expenditures and benefits, an inability to determine a reliable measurement of the future economic benefits, and the failure of capitalisation to provide useful information to users.

83. In contrast, the IASB and certain national standard-setters require development costs to be capitalised if specific criteria are met. In particular, IAS 38 distinguishes between different types of assets arising from development. Only where an entity can demonstrate all

of the following in relation to an asset arising from development would it be recognised (paragraph 57 of IAS 38):

> (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;
>
> (b) its intention to complete the intangible asset and use or sell it;
>
> (c) its ability to use or sell the intangible asset;
>
> (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
>
> (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
>
> (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

84. Although many of the factors listed in paragraph 57 of IAS 38 are indicative of probable future economic benefits, the emphasis on completion does not acknowledge that an 'unsuccessful' project may also give rise to probable future economic benefits. It also does not acknowledge that an asset may exist prior to the specific recognition criteria being met.

85. A rationale used for the capitalisation of development costs but not research costs is that development costs can be more readily associated with an identifiable project/asset. However, consistent with IFRS 3 principles, we do not think that, conceptually, there is a technical basis for treating assets arising from research differently from assets arising from development, nor treating assets arising from research and development differently from other internally generated intangible assets for recognition purposes under a cost-based model. In concept, arguably, a dollar spent prior to 'technical feasibility' does not form any less a part of the cost of an asset than a dollar spent after. Accordingly, we think that an appropriate substitute for the restrictive criterion of 'able to demonstrate technical and commercial feasibility of completion' in IAS 38 could be changed to a criterion of 'the existence of evidence of a discrete plan that is being or has been implemented', if it were not for the concerns we have expressed in paragraphs 43 and 44 above. Such a recognition criterion would be consistent with the notion of 'identifiability' in a cost-based model.

We acknowledge that some would be concerned that the future economic benefits are extremely uncertain at early stages of research and development or other discrete plans to develop intangible assets. Given this uncertainty, they are concerned that early recognition of internally generated intangible assets could result in increased impairment charges, and that this would 'clutter' the financial statements without adding to their information value. In response, we note that impairment and financial statement presentation issues are outside the scope of this Paper (see, for example, paragraph 121), and therefore, consistent with our comments in paragraph 11 above, the concern should be addressed in the context of any ongoing work relating to intangible assets.

86. The reluctance to recognise certain internally generated intangible assets in a cost-based model reflects a view that different recognition criteria from tangible assets are warranted. However, we also do not think that, conceptually, there is a technical basis for such a view. Arguably, embedding the notion of 'identifiability' in the definition of intangible assets perpetuates the perception that intangible assets are fundamentally different from tangible assets for recognition purposes. Although we accept the need to explicitly describe the characteristic of identifiability in defining intangible assets for the purpose of this Paper, we note that the same characteristic applies to, and we think has always been implicitly applied to, tangible assets. However, it does not need to be stated explicitly for tangible assets given the nature of such assets. In any case, the pertinent issue in this context for both tangible and intangible assets is the 'unit of account' issue – as we have alluded to in paragraphs 9(c)(i), 13 and 35-37 above – rather than the 'identifiability' issue.

Conclusion

87. *We conclude that, under a pure cost-based model, internally generated intangible assets that satisfy the definition of an intangible asset in IAS 38/IFRS 3 should be subject to the Framework's recognition criteria. Accordingly, only planned internally generated intangible assets should be contemplated for recognition, on the basis that the plan identifies the unit of account and it is only those types of internally generated intangible assets that could satisfy the reliable measurement (of cost) recognition criterion. They do not warrant more specific recognition criteria, although guidance on the meaning of a 'discrete plan that is being or has been implemented to create an internally generated intangible asset' would be helpful. We agree that this conclusion can be criticised because it gives undue emphasis to procedure/process (as noted in paragraphs 43 and 44 above). However, this criticism goes to the heart of the cost-based model rather than the recognition criteria per se.*

Implications for Current Requirements

88. If our conclusion in paragraph 87 above is adopted, the specific recognition requirements in paragraphs 51-61 of IAS 38 could be replaced by guidance on identifying planned internally generated intangible assets. However, it would not be necessary to amend the general 'reliable measurement of cost' recognition criteria specified in paragraph 21 of IAS 38.

APPLYING THE FRAMEWORK RECOGNITION CRITERIA UNDER A VALUATION-BASED MODEL

89. Capitalisation of costs could be a mechanism for initially recognising certain internally generated intangible assets, even under a valuation-based model. The costs could be capitalised as they are incurred and the capitalised amount subsequently adjusted up or down to fair value at reporting date. In these circumstances, cost capitalisation is a bookkeeping exercise rather than an asset measurement exercise, and as such may affect the gross amounts recognised in the statement of comprehensive income or separate income statement. Cost capitalisation may also affect the description of those amounts (for example, impairment of capitalised research and development costs rather than research and development expenses).

90. However, while the occurrence of a cost may be used as the basis for recording an asset in a valuation-based model, it is not necessary. Therefore, more internally generated intangible assets are likely to be eligible as candidates for recognition in a valuation-based model than in a cost-based model.

91. In the following, rather than directly discuss the *Framework* recognition criteria, we discuss the specific IFRS 3 recognition criteria for intangible assets acquired in a business combination and consider their suitability for internally generated intangible assets. This is on the basis that IFRS 3 provides the most recent application of the *Framework's* recognition criteria in the context of a valuation-based model for intangible assets. As we note in the following, there is arguably no useful role for recognition criteria relating to probable future economic benefits and reliable measurement when fair value is the measurement basis.

Probable Future Economic Benefits

92. IFRS 3 does not specify probable future economic benefits as an initial recognition criterion for intangible assets acquired in a business combination, because they are measured at fair value.

Paragraph BC126 that accompanies IFRS 3 (revised January 2008) states:

> The revised IFRS 3 does not contain that probability recognition criterion and thus it requires the acquirer to recognise identifiable assets acquired … regardless of the degree of probability of an inflow … of economic benefits.

93. Paragraph BC130 that accompanies IFRS 3 (and paragraph 33 of IAS 38 [as amended in January 2008 as a consequence of IFRS 3]) explains that the fair value of an intangible asset reflects expectations about the probability that the future economic benefits associated with the intangible asset will flow to the acquirer. Accordingly, the effect of probability is reflected in the measurement. We think that such a rationale is equally applicable to internally generated intangible assets if they were to be measured at fair value.

Reliable Measurement

94. Paragraph BC125 that accompanies IFRS 3 notes that the IASB decided to eliminate reliability of measurement as an overall criterion for the recognition of intangible assets acquired in a business combination, observing that it is unnecessary because reliability of measurement is a part of the overall recognition criteria in the *Framework*.

95. Furthermore, paragraph 35 of IAS 38 (amended in January 2008 as a consequence of IFRS 3) makes the presumption that:

> If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset.

96. Conceptually, if the presumption is appropriate for intangible assets acquired in a business combination, we can see no technical reason why the same presumption could not be applied to internally generated intangible assets. However, rather than discuss it further here, we consider whether the fair value of internally generated intangible assets can be reliably measured in Chapter 4.

97. Some at the Analysts Representative Group meeting with the IASB in February 2007 expressed a view that, irrespective of whether assets are acquired or internally generated, they should be treated in the same way. They noted that it would seem odd to recognise more, or fewer, intangible assets in an acquisition than an entity would recognise prior to the acquisition. There was also some acknowledgement that analysts do not look at information about intangible assets as much as

they should. Accordingly, in the following section, we consider whether IFRS 3 recognition criteria should be applied to internally generated intangible assets.

Should IFRS 3 Recognition Criteria be applied to Internally Generated Intangible Assets?

98. Lev (2001) traces the non-recognition of intangible assets to the unique attributes of intangible assets – high uncertainty regarding future outcomes, partial excludability (lack of full control) and non-tradability (page 83). He is critical of non-recognition, arguing that information deficiencies resulting from their non-recognition cause serious problems and social harm, including excessively high cost of capital for early-stage knowledge-intensive entities, systematic undervaluation by investors of intangibles-intensive enterprises, and risks of insider gains undermining confidence in the integrity of stock markets (pages 95-102).

99. Treating internally generated intangible assets differently from intangible assets acquired in business combinations can potentially produce dramatically different financial reporting outcomes, which undermines the relevance and reliability (faithful representation) of financial reports. For example, by not recognising many internally generated intangible assets, entities that grow organically may experience relatively high costs of debt and systematic undervaluation compared with entities that grow by acquisition. These organically growing entities are often less capable of dealing with relatively high costs of debt and systematic undervaluation because strategies to develop intangible assets internally, rather than through acquisition, are often characteristics of entities that are, for instance, relatively young and have limited access to external finance.[24]

100. A benefit of recognising internally generated intangible assets consistent with the recognition principles in IFRS 3 is that it is consistent with the notion of accountability. Recognition of internally generated intangible assets enables an assessment of management's accountability for such assets.

101. However, some argue that business combinations are unique types of transactions and that the principles developed for business combinations should not be applied in other circumstances. In particular, they argue that the recognition principles in IFRS 3 should not be applied to internally generated intangible assets. Their arguments include that:

24 Lev (2001), pages 93-96.

(a) IFRS 3 is only expressed in the context of purchased intangible assets and there is no valid basis for extending the principles to other circumstances, including internally generated intangible assets. Unlike many internally generated intangible assets, IFRS 3 deals with circumstances in which there is a transaction (being a business combination) providing a particular context to the recognition of intangible assets. The extent of due diligence typically associated with a business combination provides a cost-effective context for recognising intangible assets only in those circumstances;

(b) it is evident from paragraph BC158 that accompanies IFRS 3 that the primary rationale for the IASB adopting the approach in IFRS 3 is to minimise the risk of goodwill arising in a business combination otherwise including value attributable to intangible assets. Paragraph BC158 accompanying IFRS 3 states: "… the decision-usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill…" Such a rationale is not relevant to the recognition of internally generated intangible assets because internally generated goodwill (consideration of which is outside the scope of this Paper – see paragraph 10(a) above) is not recognised. Typically, under IFRS 3, the recognition of an intangible asset acquired in a business combination would not increase net assets. It merely substitutes one asset (an intangible asset) for what would otherwise be recognised as another asset (goodwill). Therefore, on the assumption that it is inappropriate to recognise internally generated goodwill and that it is not the primary purpose of a statement of financial position to provide a business valuation, the risks of undermining the quality of financial statements by overstating net assets are arguably higher if an internally generated intangible asset is recognised;

(c) under current IASB standards, not only are intangible assets acquired in a business combination treated differently from intangible assets that arise in other ways, but tangible assets, such as property, plant and equipment acquired in a business combination are treated differently from internally generated tangible assets. Some argue that internally generated intangible assets should be accounted for in the same way that internally generated tangible assets (rather than intangible assets acquired in a business combination) are accounted for. This would be consistent with our conclusion in paragraph 87 – see also paragraphs 124-135 in Chapter 4. Those who argue such a view acknowledge that the approach would more than

likely result in the recognition of fewer internally generated intangible assets than if the principles in IFRS 3 are applied. However, they argue that it would conceivably result in the recognition of more internally generated intangible assets than are currently permitted to be recognised under IAS 38; and

(d) attempting to value internally generated intangible assets based on a hypothetical transaction has the potential to produce a result that is neither relevant nor representationally faithful.

Some conclude that these factors provide a conceptual justification for recognising intangible assets acquired in business combinations and not necessarily recognising the same types of intangible assets that are internally generated.

102. From a more practical perspective, implementation experience to date with IFRS 3 (issued March 2004) is mixed as to whether it provides support for applying the principles in IFRS 3 to the initial accounting for internally generated intangible assets. In particular:

(a) Intangible Business Ltd is critical of the way entities applied IFRS 3 in the initial year of implementation of IFRS 3, stating that:

> the spirit of IFRS 3 is not being followed … accounting for business acquisitions is still opaque and creative accounting is still occurring … intangible assets have been reported at under values. (page 5)

Its report speculates on the reasons for inadequate reporting under IFRS 3, noting the incentives managements have to minimise the values of intangible assets and maximise goodwill due to amortisation and impairment implications and the lack of specialist skills to implement IFRS 3;

(b) in contrast, a study undertaken by Mintchik (2006) on the initial year of implementation experience of SFAS 141 (broadly equivalent to IFRS 3) concludes that SFAS 141 was effective in achieving greater transparency of financial reporting after mergers. The study states that the:

> Results provide strong evidence that earnings forecast errors decreased for companies involved in merging and acquisition activity after the adoption of SFAS 141. (page 26)[25]

(c) PricewaterhouseCoopers (2007) found that seventy-four percent of respondents described the item 'intangible assets' recognised in the balance sheet as "not useful":

> None of the respondents uses balance sheet information on acquired intangible assets – for example, customer lists or brands. The majority of interviewees believe that the current allocation of purchase price, required under both IFRS and US GAAP, does not provide useful information. (page 7).

Arguably, some of the disinterest in balance sheet information about intangible assets may be a consequence of consolidated accounts only recognising intangible assets related to specific subsidiaries and it is this 'piecemeal' information that is not adequate for investor needs. For instance, where an acquirer purchases a competitor that holds, for example, brands that compete directly with those of the acquirer, the overall consequences of the business combination may be unclear from the group's financial statements because internally generated brands held by the acquirer are not recognised. Perhaps the availability of information about the intangible assets of the entire group would be more meaningful. However, we acknowledge that the disinterest in balance sheet information found by PricewaterhouseCoopers may instead arise from apprehension about the credibility of recognised amounts; and

(d) Canadian UAC members provided us with comments on their experience with the Canadian Standard, CICA 1581 *Business Combinations*, the requirements of which correspond with those of IFRS 3. In general, they expressed a view that the information on intangible assets acquired in business combinations being provided by acquirers in accordance with CICA 1581 is useful for decision-making, although additional supplementary disclosures would enhance the information currently being provided. The majority expressed doubt about whether CICA 1581 is being applied as it was originally

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25 Mintchik, N.M. (2006). 'The Effect of SFAS No. 141 on the Transparency of Business Combination Reporting: Evidence from the Initial Year of Implementation', *Working Paper*, University of Missouri at St. Louis, March. The paper goes on to note that the improvement in financial reporting transparency more likely follows from the extended disclosure requirements and the other required changes in the purchase method rather than from the elimination of the pooling of interests method.

intended. Some view this as being due to the difficulty of reliable measurement, resulting in intangible assets not being separately recognised. They expressed a view that intangible assets that are difficult to quantify and measure are not being separately identified and are being included in goodwill. Consistent with comments made by Intangible Business Ltd (see paragraph 102(a) above), a venture capitalist suggested that, under the current requirements, entities have an incentive to include finite life intangible assets with goodwill in order to avoid amortisation. Others noted that intangible assets are being separately recognised but at an amount less than fair value. Some of the users surveyed accept the manner in which CICA 1581 is being applied on the basis that intangible assets are generally not material in comparison with total assets. One investor noted that, from a financial statement analysis perspective, many analysts view goodwill and intangibles as similar.

103. Some argue that, given the way IFRS 3 is implemented in practice, it would not be appropriate, or indeed in some cases it would be impossible, to adopt a similar approach for internally generated intangible assets. This is particularly the case where practice has continued to treat the recognition of assets and liabilities acquired in a business combination as a cost allocation exercise, and to recognise and measure intangible assets by taking into account an acquirer's intentions.

104. Although this view needs to be acknowledged as a potential impediment to the recognition of internally generated intangible assets using IFRS 3 recognition principles, we think that it should be rejected on the basis that it is in direct conflict with the requirements in IFRS 3 (see paragraph 74 of this Paper). Furthermore, the failure to fully adopt the requirements in IFRS 3 may represent a transitory response by individual practitioners to the relatively new accounting requirements. Consequently, as practitioners become more familiar with applying the requirements in IFRS 3, resistance to recognising internally generated intangible assets on the basis of the principles in IFRS 3 may reduce over time.

105. Some assert that investors would not act differently even if more intangible assets were to be recognised and therefore changes to current requirements cannot be justified. They argue that information about such assets is available from other sources, such as through existing note disclosures or management briefings. In some circumstances, assets are known to exist and their values are known, by virtue of the nature of an entity. However, management has a comparative advantage in providing information about intangible

assets in financial reports and therefore investors could presumably access the information at a lower cost if management were to provide it through financial reports. Furthermore, although relatively highly sophisticated users may be able to access information to compensate for non-recognition, other users may not be in such a privileged position. As noted by Lev,[26] such inequalities of access to information can undermine the efficiency of capital markets.

106. During the dot-com bubble period (roughly 1995-2001[27]) there were major gaps between book values of many start-up and high-tech businesses and their perceived business values. At the time, these gaps led to some calls for standard-setters to give consideration to improving accounting for intangible assets. With the bursting of the bubble, those major gaps closed considerably or evaporated with the demise of many of those businesses. Accordingly, those changes leave some commentators less confident about the true depth and nature of users' needs that may have been perceived by some during the dot-com bubble period.

107. A technique we contemplated in Chapter 2 for basing the identification of internally generated intangible assets on IFRS 3 principles is a technique based on a hypothetical business combination. Such a technique is criticised by some on cost-benefit grounds. To address concerns that the hypothetical business combination technique is too costly, some advocate more pragmatic techniques that effectively use asset identification techniques as recognition filters. In light of our discussion in paragraphs 98-106 above, we consider more pragmatic techniques in paragraphs 108-111 below.

Recognise an Internally Generated Intangible Asset only when there is any Indicator that it Exists

108. Instead of a technique based on a 'hypothetical business combination', an 'any indicator technique' could be adopted, whereby only when there is an indication that an internally generated intangible asset exists as at reporting date should it be considered for recognition. Examples of possible indicators include:

    (a) a documented discrete plan to create a particular intangible asset. The existence of the plan would cause management to consider whether an internally generated intangible asset exists;

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26 Lev, B. (1980). 'Toward a theory of equitable and efficient accounting policy', *The Accounting Review*, Volume 63, pp. 1-22.

27 http://en.wikipedia.org/wiki/Dot-com_bubble (October 2008).

(b) a documented strategy to manage an asset that, although not developed under a discrete plan, exists at reporting date and has been identified by management as worthy of its attention. This is similar to the approach taken in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, whereby an asset cannot be classified as held for sale unless the appropriate level of management is committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan has been initiated (see paragraph 8 of IFRS 5); and

(c) an external source, such as an uninvited offer from a third party to acquire an internally generated intangible asset that had not previously been identified by management.

109. An advantage of this technique is that it is less costly than a technique based on a hypothetical business combination technique. A disadvantage is that it risks the non-recognition of certain internally generated intangible assets that satisfy the *Framework's*/IFRS 3's asset recognition criteria. Another disadvantage is that, in the absence of an external indicator, identification/recognition depends on the actions of management, resulting in loss of comparability between entities.

Recognise an Internally Generated Intangible Asset only when it is Indicated by a Discrete Plan

110. Another technique for identifying internally generated intangible assets to be considered for recognition would be to only identify assets when they are in the process of being developed or have arisen from the completion or abandonment of a discrete plan. As we noted in paragraph 45, a challenge for a standard-setter would be to define the distinction between planned and unplanned internally generated intangible assets in a robust way.

111. An advantage of this technique is that it is even less costly than the 'any indicator technique' described in paragraph 108 above. Also, some argue that it has the advantage that it results in the recognition of the same internally generated intangible assets that would be recognised under a cost-based model (albeit measured differently). Furthermore, it is consistent with the requirements in IAS 16 for the recognition of internally generated property, plant and equipment. However, the technique is arguably more effective in the context of tangible assets because such assets tend not to emerge from unplanned activities, and when they do they are obvious and therefore not costly to identify. Therefore, a major disadvantage of this technique is that it fails to contemplate the recognition of unplanned internally generated intangible assets.

Conclusion

112. The conceptual and practical challenges of identifying intangible assets and applying the *Framework's*/IFRS 3's asset recognition criteria are overcome in a business combination primarily because fair value is the required measurement base. In concept, if a valuation-based model is adopted, internally generated intangible assets could be treated in the same way as the same type of assets acquired in a business combination.

113. *We conclude that, under a valuation-based model, internally generated intangible assets that satisfy the definition of an intangible asset in IAS 38/IFRS 3 should be subject to the same recognition requirements for intangible assets acquired in a business combination, using a technique based on a hypothetical business combination. Accordingly, all internally generated intangible assets that would be recognised if acquired in a business combination under IFRS 3 should be recognised. While less onerous identification techniques or recognition criteria could be adopted, they have significant conceptual shortcomings.*

Implications for Current Requirements

114. Our conclusion is significantly different from the current general recognition requirements for internally generated intangible assets contained in paragraph 21 of IAS 38 because IAS 38 does not contemplate initial fair value measurement. However, we acknowledge that, although IAS 38 does not require initial fair value measurement, the 'cost' amount may sometimes be the same as fair value on initial recognition. Despite this, if a valuation-based model were to be adopted for internally generated intangible assets, IAS 38 would need to be substantially amended.

115. Our conclusion in paragraph 113 of this Paper is also significantly different from the specific recognition requirements in paragraphs 51-61 of IAS 38. The implementation of our conclusion, therefore, would involve substantial amendments to those requirements. For instance, if a valuation-based model were to be adopted, the requirements in paragraphs 63 and 64 of IAS 38, which prohibit the recognition of internally generated brands, mastheads, publishing titles, customer lists and items similar in substance to intangible assets, would need to be removed.

INTERVIEWEES' PERSPECTIVES

Probable Future Economic Benefits

116. Two interviewees from large accounting firms specifically noted that, prior to the introduction of IFRS 3, they were inclined to regard the future economic benefits attributable to an internally generated intangible asset as probable, but only if the asset was capable of being protected (for instance, a registered trademark existed) and/or was capable of being transferred/sold to a third party (that is, separable). One of these interviewees suggested that legal ownership is a sufficient but not a necessary condition for recognising an internally generated intangible asset, noting several situations where entities had undertaken civil proceedings to establish common law entitlements based on a pattern of use over internally generated brand names. Those from the consumer product firms interviewed expressed similar views to those from the large accounting firms.

117. A number of interviewees also regarded internally generated intangible assets such as software development expenditures and customer/mailing lists, which are not normally underpinned by explicit legal rights, as assets that typically satisfy the 'probable future economic benefit' asset recognition criterion.

Reliable Measurement

118. All of the interviewees from the large accounting firms and one from the consumer product corporations noted that reliability of measurement is a function of the inherent nature of the intangible asset and the availability of relevant data. This applies irrespective of whether the internally generated intangible asset is measured at cost or other value. For instance, mature brand names with a history of earnings are normally regarded as more reliably measurable than untested internally generated software or intellectual property that is still in a developmental stage. A history of earnings provides input for reliable estimates of future revenues and expenses. In addition, the availability of sales and licensing information for brand names through subscriber databases[28] facilitates the use of measurement methods such as the relief from royalty approach. In contrast, it may not be possible to reliably measure a cost for internally generated software or intellectual property due to inadequate or non-existent accounting records.

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28 For instance, RoyaltySource (www.royaltysource.com), SDC Platinum (www.thomsonib.com/sp.asp) and Royaltystat (www.royaltystat.com).

119. Further comments on whether the fair value of internally generated intangible assets can be reliably measured are contained in paragraphs 161-164 below.

CHAPTER 4 – MEASUREMENT

INTRODUCTION

120. In this Chapter we consider the main issues relating to the initial measurement of internally generated intangible assets, in particular whether the *Framework's* recognition criterion of reliable measurement of cost or value can be satisfied. Despite the presumption in paragraph 33 of IFRS 3 that the fair value of intangible assets (as defined) acquired in a business combination can be reliably measured, given the controversial nature of that presumption, we consider the suitability of the presumption for internally generated intangible assets. We conclude the Chapter with our view on the basis upon which internally generated intangible assets should be required to be initially measured.

121. Under a cost-based model, it is conceivable that cost exceeds recoverable amount on the initial recognition of an asset and therefore questions of impairment arise. However, consistent with our earlier comments, because impairment issues only arise in a subsequent accounting context for a completed asset, we do not consider them in detail further in this Paper. Furthermore, although impairment can arise in an initial accounting context given the way we define initial accounting in relation to in-process assets (see paragraph 11 above), we also do not consider it in detail further in this Paper, although we do acknowledge it where pertinent. Similarly, in relation to a valuation-based model, we only consider the initial accounting for internally generated intangible assets and not whether changes in value should be recognised and how any changes in value should be presented in the financial statements. Consistent with our earlier comment, we think that future research needs to consider issues relating to the subsequent accounting for internally generated intangible assets in both a cost-based model (including impairment issues) and a valuation-based model. From a subsequent measurement perspective, it is relevant to note that paragraph 100 of the Basis for Conclusions accompanying SFAS 19 *Financial Accounting and Reporting by Oil and Gas Producing Companies* (December 1977) contemplates 'discovery-value accounting', in which assets are initially measured at fair value but are not subsequently subject to remeasurement.

MEASUREMENT OF INTERNALLY GENERATED INTANGIBLE ASSETS AT COST

122. In relation to cost-based measurement, many users have described the current model under IAS 38 as confusing, particularly as some research and development expenditure is capitalised and some

expensed. A concern expressed by some at IASB measurement roundtables is that failure to capitalise costs incurred on many internally generated intangible assets allows entities to manage earnings (particularly in the short-term) by, for example, reducing research and development expenditure. A minority of PricewaterhouseCoopers (2007) interviewees supported the capitalisation of research and development; a majority expressed a view that research and development should be expensed.

123. In paragraphs 124-135 below we consider an approach whereby internally generated intangible assets are initially measured in the same way as internally generated tangible assets (property, plant and equipment) – historical cost. In particular, we consider the suitability of the broad cost-based principles in IAS 16 for internally generated intangible assets. These principles are broadly aligned with paragraphs 65-67 of IAS 38, although IAS 38 applies them to a narrow group of internally generated intangible assets and commences capitalisation at a later stage in the process of developing an asset.

124. As implied by paragraph 316 of the IASB's Discussion Paper *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*, prepared by staff of the Canadian Accounting Standards Board (November 2005), there are generally accepted standards for the historical cost measurement of assets that can be adapted to internally generated intangible assets. Although it is acknowledged that the frequent need to allocate on a one-to-many basis can be criticised, this criticism can equally be levelled at the initial measurement of property, plant and equipment under IAS 16. Moreover, cost allocation methods are well entrenched in accounting practice.

125. A core issue to be addressed in relation to the initial accounting for costs associated with intangible items, and therefore initial measurement under a cost-based model, is identifying the costs, if any, that should be initially capitalised (and therefore initially recognised as part of the cost of an asset) and the costs that should be initially written-off (and therefore recognised as expenses). In the remainder of this section we outline issues relevant to the capitalisation of historical costs.

Initial Treatment of Costs

126. For any particular cost relating to developing an internally generated intangible asset the alternatives seem to be:

(a) expense it immediately, and permanently;

(b) expense it initially, and reinstate it to a subsequently identified attributable asset;[29]

(c) capitalise it to an attributable asset for as long as successful completion of the asset is expected and expense it if it is subsequently found to be unsuccessful (a 'successful efforts' method);

(d) expense it unless technical and commercial feasible of completion of an asset can be demonstrated, in which case capitalise it (as prescribed currently in IAS 38); and

(e) capitalise it to an attributable asset (subject to impairment testing).

Where an asset does not exist, costs would be expensed.

127. Treatments (a)-(d) are inconsistent with our conclusions drawn earlier in this Paper. In particular:

(a) treatment (a) ignores that an asset (probable future economic benefits) may initially exist, for example, in relation to a potentially ultimately successfully or unsuccessfully implemented discrete plan;

(b) treatment (b) also ignores that an asset may initially exist with a positive value, where, for example, a discrete plan that is being implemented for research and development has the potential to be ultimately successful. Furthermore, treatment (b) ignores that an asset may initially and subsequently exist with a positive value, even if a discrete plan is implemented unsuccessfully. In addition, we are not aware that 'reinstatement' has ever been supported conceptually as being appropriate in a cost-based system. Some argue that the treatment (b) result can be better achieved by capitalising a cost relating to developing an internally generated intangible asset and simultaneously raising a valuation allowance (impairment) for the same amount. This is effectively the same as treatment (b), except that reversal of impairment is regarded as 'easier' to achieve than the reinstatement of previously expensed costs under current accounting standards. However,

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29 For instance, Lev (2001) proposes the recognition as assets of all intangible investments with attributable benefits that have passed certain pre-specified technological feasibility tests and that, once asset recognition commences (post-feasibility test), all the project-related previously expensed research and development should also be recognised as assets. (pages 124 and 125)

the simultaneous recognition of impairment on initial recognition is a fundamental contradiction because, in this context, impairment is a subsequent rather than an initial accounting issue;

(c) treatment (c) fails to acknowledge that an impairment may arise prior to the outcome of a discrete plan being known, and by writing off all costs incurred in implementing a discrete plan that is expected to be unsuccessful, again ignores that an asset may exist in relation to unsuccessfully implemented discrete plans; and

(d) treatment (d) fails to take account of the existence of an asset prior to demonstrable technical or commercial feasibility of completion.

128. Where an asset is being created, it would be appropriate to capitalise costs up until completion or abandonment of the discrete plan relating to that asset, subject to a write-down to recoverable amount where necessary – treatment (e). Consistent with our comments in paragraph 11 above, the initial accounting for an internally generated intangible asset being developed under a discrete plan occurs up to completion or abandonment of the plan, and therefore an asset in the nature of work in process may exist before the asset being created exists. Impairment considerations would include assessments of the probability of success of the discrete plan and the outcome being kept secret or protected in some way.

129. An internally generated intangible asset may be identified with the benefit of hindsight only after some attributable costs have been incurred and expensed. This possibility arises in relation to tangible assets as well as intangible assets, although the problem is more acute for intangible assets. A question arises as to whether in these cases only costs subsequent to the realisation that an asset exists should be capitalised and whether the previously expensed costs should be reversed and thereby capitalised. Capitalising costs only after identification of the asset sometime after it comes into existence would not provide a reliable measure of the total cost of the asset. Although capitalising those costs and reversing previously expensed but attributable costs may provide a measure of cost, it would be questionable as to whether retrospective attribution of costs to internally generated intangible assets could be undertaken reliably and it would raise concerns about reinstatement (see our comments in paragraph 127(b) above). It is likely that such circumstances indicate the existence of an unplanned (rather than a planned) internally generated intangible asset and therefore would not be recognised under a traditional view of a cost-based model.

130. In addition to IAS 16 (see paragraphs 16-22 for example in relation to their discussion of the costs of self-constructed property, plant and equipment), other relevant IASB standards that contain pertinent principles/guidance for cost allocation under treatment (e) include:

    (a) IAS 1 *Presentation of Financial Statements* (see paragraph 103);

    (b) IAS 2 *Inventories* (see paragraphs 10-22); and

    (c) IAS 11 *Construction Contracts* (see paragraphs 16-21).

131. Consistent with these standards, costs allocated to internally generated intangible assets would include:

    (a) direct costs (labour, materials, services); and

    (b) indirect costs (allocation of appropriate operating overhead).

Can the Cost of Internally Generated Intangible Assets be Reliably Measured?

132. In relation to planned internally generated intangible assets, Upton (2001) observes:

> From a purely bookkeeping standpoint, measuring the cost of these intangibles doesn't present any insurmountable accounting problems. (page 70)

133. The consensus amongst preparers and their advisors who were interviewed for the purpose of this Paper, particularly those from large accounting firms, consumer product corporations and one of the financial services corporations, was that the difficulties associated with identifying the costs to include in the asset base limit the use of historical cost. Nevertheless, all of the interviewees, particularly those from large accounting firms, expressed a view that historical cost could provide a reliable measurement for some types of internally generated intangible assets, including research and development, software for internal administrative purposes and intellectual property, provided that the entity maintains adequate financial records. One of the large accounting firms interviewed noted that the quality of accounting systems normally varies between entities. We think that, in the circumstances we contemplate in this Paper, the adequacy of record keeping is a transitional issue, which is common to many 'new' requirements.

Conclusion

134. *We conclude that cost is not a suitable basis for measuring unplanned internally generated intangible assets because there is no basis for reliably attributing costs. However, if a cost-based model were adopted, it is reasonable to presume that historical cost can be reliably measured for planned internally generated intangible assets from the commencement of implementing the plan up until completion or abandonment of the plan, based on the principles in IASB standards for allocating costs to other types of assets. Therefore, the attributable costs of planned internally generated intangible assets should be required to be recognised (capitalised) as an asset. A transitional period may be warranted to allow entities time to develop adequate accounting systems.*

Implications for Current Requirements

135. Our conclusion in paragraph 134 is broadly consistent with the current requirement in IAS 38 for the measurement of intangible assets arising from development that have satisfied the specified criteria. Implementation of our conclusion, therefore, would involve no additional changes to the requirements in IAS 38, so far as they relate to development that has satisfied the IAS 38 specific criteria.

136. However, changes to facilitate recognition and measurement at cost of research, recognition of costs incurred prior to the IAS 38 specific criteria for development, and recognition and measurement of other planned internally generated intangible assets (such as planned brand names), would be necessary. For instance, the requirements relating to cost allocation in paragraphs 65-67 of IAS 38 would need to be amended to align with the more general principles of cost allocation. It would also be necessary to amend paragraph 65 of IAS 38, which specifies, by cross-reference to paragraph 57 of IAS 38, that cost capitalisation only commences from the date the asset arising from development first meets the specific recognition criteria.

MEASUREMENT OF INTERNALLY GENERATED INTANGIBLE ASSETS AT FAIR VALUE

137. The IASB Fair Value Measurement project is developing guidance for measuring fair value. To date, the IASB has issued Discussion Paper *Fair Value Measurements* (November 2006), part 1 of which is an Invitation to Comment and relevant IFRS guidance. In the context of IASB/FASB convergence, the Discussion Paper provides the IASB's preliminary views on the principal issues contained in SFAS 157 (which establishes a single definition of fair value together with a framework for measuring fair value for US GAAP). SFAS 157 is a

product of a standards-level project rather than a conceptual-level project in that it does not prescribe fair value measurement. Rather, it provides guidance on the determination of fair value if standards specify such measurement. Because the Discussion Paper reflects the latest available documented thinking of the IASB on fair value measurement, we discuss fair value measurement of internally generated intangible assets within its context. This is despite the fact that the IASB has not expressed a preliminary view on all the issues in SFAS 157, nor does it necessarily agree with all aspects of SFAS 157.

138. Of particular significance to us is that the Discussion Paper indicates there is a consensus at the IASB on the suitability of a fair value hierarchy such as the one in SFAS 157. Accordingly, in paragraphs 140-171 of this Paper we consider the implications of the SFAS 157 fair value hierarchy for the initial measurement of internally generated intangible assets under a valuation-based model.

139. During the finalisation of this Paper, the notion of fair value came under intense scrutiny in the context of the 'credit crisis'. Much debate was taking place on the suitability of fair value and the methods used for its determination in the absence of active markets, particularly in relation to financial assets. Despite this debate, we regard fair value, as described in the literature as at October 2008, provides a sound basis for consideration of the issues addressed in this Paper. Accordingly, in the remainder of this Chapter we discuss the suitability of the initial fair value measurement of internally generated intangible assets in the context of the current literature.

Measuring Fair Value

140. There are mixed views on whether fair value should be defined in terms of an entry price model or an exit price model. A discussion of the relative merits of the two models is outside the scope of this Paper as it will be addressed more broadly in the context of the IASB's Fair Value Measurement project. In the meantime, we accept for the purpose of this Paper the definition of fair value provided in paragraph 5 of SFAS 157:[30]

> … the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

30 References to, and extracts from, SFAS 157 contained in this Paper relate to the version of SFAS 157 included in the IASB's November 2006 Discussion Paper *Fair Value Measurements*.

Although this is consistent with an exit price model, our focus is on the hierarchy rather than the definition as such.

141. SFAS 157 establishes a three-level hierarchy that prioritises the inputs to valuation techniques used to measure fair value. We discuss each level of the hierarchy below in the context of internally generated intangible assets. Our discussion also includes a comparison of IAS 38/IFRS 3's current requirements for the fair value measurement of intangible assets acquired in business combinations with the SFAS 157 requirements.

Level 1 of the Fair Value Measurement Hierarchy: Use of Observable Inputs

142. Paragraph 24 of SFAS 157 describes Level 1 inputs as:

> quoted prices (unadjusted) in active markets for identical assets … that the reporting entity has the ability to access at the measurement date. An active market for the asset … is a market in which transactions for the asset … occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

143. The relevant extract from IAS 38 (paragraph 39) relating to the initial measurement of intangible assets acquired in business combinations that broadly corresponds to Level 1 is as follows:

> Quoted market prices in an active market provide the most reliable estimate of the fair value of an intangible asset (see also paragraph 78). The appropriate market price is usually the current bid price. …

144. Although the IAS 38 description is different from the SFAS 157 description, it is apparent that their outcomes would be broadly the same. Therefore, if the requirements in SFAS 157 were adopted for internally generated intangible assets and incorporated into a stand-alone fair value measurements standard, it would be possible to delete the requirements in paragraph 39 of IAS 38 cited above and allow the requirements in a fair value measurements standard to apply in their own right.

Level 2 of the Fair Value Measurement Hierarchy: Use of Observable Inputs and
Level 3 of the Fair Value Measurement Hierarchy: Use of Unobservable Inputs

145. Paragraph 28 of the SFAS 157 describes Level 2 inputs as:

> inputs other than quoted prices included within Level 1 that are observable for the asset … either directly or indirectly.

The paragraph goes on to explain that the observable inputs to which it refers include quoted prices for similar assets in active markets; quoted prices for identical or similar assets in markets that are not active; and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

146. Paragraph 30 of SFAS 157 describes Level 3 inputs as:

> unobservable inputs for the asset … Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset … at measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset … Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset … (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

147. Paragraph A25 of SFAS 157 states that:

> Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value … and/or the risk inherent in the inputs to the valuation technique.

148. The relevant extract from IAS 38 (paragraphs 39-41) relating to the measurement of intangible assets acquired in business combinations that broadly corresponds to Level 2 and Level 3 is as follows:

> … If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.
>
> If no active market exists for an intangible asset, its fair value is the amount that the entity would have paid for the asset, at the acquisition date, in an arm's length transaction between knowledgeable and willing parties, on the basis of the best information available. In determining this amount, an entity considers the outcome of recent transactions for similar assets.
>
> Entities that are regularly involved in the purchase and sale of unique intangible assets may have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in a business combination if their objective is to estimate fair value and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, when appropriate:
>
> (a) applying multiples reflecting current market transactions to indicators that drive the profitability of the asset (such as revenue, market shares and operating profit) or to the royalty stream that could be obtained from licensing the intangible asset to another party in an arm's length transaction (as in the 'relief from royalty' approach); or
>
> (b) discounting estimated future net cash flows from the asset.

149. IAS 38 describes the techniques differently from SFAS 157's description. For example, IAS 38 refers specifically to a potential need to address changed economic circumstances, that is, it specifically highlights that prices might be those from the past. Furthermore, IAS 38 prescribes an entry price (being the amount that the entity would have paid for the asset – paragraph 40 of IAS 38) rather than an exit (selling) price prescribed by SFAS 157. Despite these differences, IAS 38's and SFAS 157's outcomes would be broadly the same.

150. If the SFAS 157 requirements were adopted for internally generated intangible assets, it would be inappropriate to delete entirely paragraphs 39-41 of IAS 38 in the event that a stand-alone fair value

measurements standard is issued to the extent they provide useful clarification of the application of fair value measurement for intangible assets, including internally generated intangible assets.

Can the Fair Value of Internally Generated Intangible Assets be Reliably Measured?

151. Paragraph 2(b) of SFAS 157 anticipates that the fair value of certain assets cannot be reliably measured. In particular, it notes that:

> This Statement does not eliminate the practicability exceptions to fair value measurements in accounting pronouncements within the scope of this Statement.

152. Whether Levels 1 to 3 inputs as described in SFAS 157 are available for determining the fair value of a particular internally generated intangible asset (or group of assets that includes one or more internally generated intangible assets) is a question of fact, in the same way that it is a question of fact for intangible assets acquired in business combinations.

153. However, as we noted in paragraph 95 of this Paper, IAS 38, in specifying requirements for the measurement of intangible assets acquired in a business combination, asserts that a reliable measure of fair value can be determined in all circumstances where the asset is separable or arises from contractual or other legal rights. This is noted in paragraphs 35-37 of IAS 38:

> If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset. When, for the estimates used to measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities, that uncertainty enters into the measurement of the asset's fair value.
>
> An intangible asset acquired in a business combination might be separable, but only together with a related tangible or intangible asset. For example, a magazine's publishing title might not be able to be sold separately from a related subscriber database, or a trademark for natural spring water might relate to a particular spring and could not be sold separately from the spring. In such cases, the acquirer recognises the group of assets as a single asset separately from goodwill if the individual fair values of the assets in the group are not reliably measurable.
>
> Similarly, the terms 'brand' and 'brand name' are often used as synonyms for trademarks and other marks. However, the former are

> general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise. The acquirer recognises as a single asset a group of complementary intangible assets comprising a brand if the individual fair values of the complementary assets are not reliably measurable. If the individual fair values of the complementary assets are reliably measurable, an acquirer may recognise them as a single asset provided the individual assets have similar useful lives.

154. Arguably, consistent with paragraph 54 of this Paper, determining the fair value of an internally generated intangible asset of an entity is less onerous for the entity than determining the fair value of an intangible asset acquired in a business combination because the entity presumably knows its own assets better than assets it acquires in a business combination, particularly in a 'hostile' business combination. It is relevant to note that paragraph 30 of SFAS 157 (quoted in paragraph 146 above) does not require an entity to undertake all possible efforts to obtain information about market participant assumptions, but requires it to do so if it is reasonably available without undue cost and effort.

155. Consistent with paragraphs 35-37 of this Paper, irrespective of the Level of the fair value measurement hierarchy adopted and the manner in which the intangible asset arises, measurement of fair value would need to have regard to the economic phenomenon reflected in the descriptor of the asset. Care must be taken not to double-count value by including it in more than one asset. Paragraph 43 of IAS 36 *Impairment of Assets* provides some guidance on the double-counting issue. It indicates that, to avoid double-counting, estimates of future cash flows do not include cash inflows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review. The value attributed to the asset as it is described should not include the value of attributes unless its inclusion would be generally understood by users through the descriptor. For example, an entity may have proprietary technology or know-how and apply it when servicing its customers. The assets of the entity would include technology, know-how, workforce[31] and customer relationships. When measuring the individual intangible assets, care must be taken to avoid double-counting or overlap between assets.

156. Some industries or countries may have more Level 1 or Level 2 data than others. For example, in some countries intangible assets may be

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31 Paragraph B37 of IFRS 3 notes that:

> Because the assembled workforce is not an identifiable asset to be recognised separately from goodwill, any value attributed to it is subsumed into goodwill.

traded and therefore Level 1 or Level 2 inputs may be available. However, in other countries where the same kind of assets are not traded, only Level 3 inputs may be available.

157. Even if it is concluded that Levels 1 and 2 inputs are not available for some internally generated intangible assets currently, new markets for intangible assets may emerge in the future as markets develop. A financial analyst interviewed by us for the purpose of this Paper commented that markets are emerging as increasingly more transactions in internally generated intangible assets, such as brand names, occur. However, currently there is limited information provided in financial reports about such transactions to inform the market and facilitate analysis by market participants.

158. Furthermore, there is empirical evidence to suggest that the fair value of many types of internally generated intangible assets can be reliably determined. For example, anecdotal evidence indicates that there have been a number of business combinations where internally generated intangible assets were central to the negotiations and that the market effectively valued these items prior to the actual takeover. Two examples of business combinations where internally generated intangible assets were a significant focus of the negotiations and had an observable impact on the acquisition price include the business combination of the German telephony company Mannesmann Mobilfunk by British Vodaphone in 2000 (customer contracts and intellectual property) and the business combination between America Online and Time Warner in 2001 (subscriber lists and customer contracts).

159. Applying IFRS 3 measurement principles to internally generated intangible assets by analogy raises the question as to whether the principles in IFRS 3 relating to provisional accounting are applicable to an internally generated intangible asset. An inability to reliably measure fair value differs from the provisional accounting situation that is anticipated in paragraphs 45-50 of IFRS 3 for the initial accounting for a business combination. As discussed in paragraphs BC390-BC400 that accompany IFRS 3, the IASB regards the use of provisional values as a practical solution to situations where required inputs are not available until after the acquisition date. This can particularly arise in hostile takeovers and in jurisdictions where laws/regulations make it difficult to provide access to sensitive information about targets before a deal closes. In contrast to these circumstances, where an internally generated intangible asset satisfies the definition and separate recognition criteria at the reporting date, its final fair value would be available and therefore the provisional accounting contemplated in IFRS 3 would not be applicable.

160. Comments by people interviewed by us for the purpose of this Paper indicate that fair values can be reliably determined for many internally generated intangible assets, although questions about the need for, and concerns about the veracity of, those values were expressed by some users (financial analysts). We outline the results of our interviews and other research into the views of various parties in paragraphs 161-188 below.

Perspectives of Preparers of Financial Reports and Their Advisors

161. All of those preparers and their advisors interviewed by us for this Paper noted the trade-off between relevance and reliability that occurs when selecting between different measurement methods for internally generated intangible assets. Most interviewees indicated that, prior to the introduction of IAS 38, they adopted a hierarchical approach broadly similar to that reflected in SFAS 157 when selecting an appropriate measurement method for internally generated intangible assets, although they also applied measurement at cost as a surrogate for fair value in certain circumstances. For the majority of interviewees, particularly those from large accounting firms and consumer product corporations, amounts determined using Level 1 inputs or Level 2 inputs are preferred over all other measurement methods for measuring internally generated intangible assets. Furthermore, interviewees indicated that, if reporting entities were permitted or required to recognise internally generated intangible assets, the measurement methodologies currently being applied to initially measure intangible assets acquired in business combinations under IFRS 3 (and therefore paragraphs 39-41 of IAS 38) are likely to be similarly applied to internally generated intangible assets.

162. A number of the interviewees, particularly those from the large accounting firms, consumer product corporations and one of the telecommunications and broadcasting corporations, noted that the lack of readily observable market prices (Level 1) for some intangible assets, including brand names, research and development, internally generated software and intellectual property, had constrained them and/or entities they dealt with from recognising internally generated intangible assets in the past. Nevertheless, most of the interviewees felt that this alone would not prevent the determination of a reliable measure of some internally generated intangible assets for external financial reporting purposes.[32] The most important factor mentioned by interviewees in relation to the determination of a reliable measure

32 Although management would be expected to understand measurements derived for internal purposes, it is possible that external users could be misled by those measures. Therefore, reliable measurement for external financial reporting purposes is arguably a higher hurdle than for internal reporting purposes.

of an internally generated intangible asset was whether the cash flows attributable to the intangible asset could be separately identified (relevant to Level 3 of the fair value measurement hierarchy). In any case, in the absence of observable market prices for a directly comparable intangible asset, some interpretation and adjustments of information obtained from subscriber databases (Level 2) were necessary to ensure that the measurement attributed to a particular intangible asset represented a reliable measurement for external financial reporting purposes.

163. A number of the interviewees, particularly those from the large accounting firms and consumer product corporations, noted their experience with measurement models based on entity-specific information and expectations (potentially Level 3 of the fair value measurement hierarchy). This is particularly the case where the market for the intangible asset is relatively immature and consists of few observable market transactions, or the intangible asset has a number of unique characteristics that make direct comparisons with assets in other markets difficult. Consequently, these interviewees indicated that, if fair value as described under Level 1 could not be reliably measured, they would first seek an appropriate measurement method based on market-specific data and expectations (fair value as described under Level 2) and entity-specific data and expectations (potentially Level 3). Interviewees indicated that measurement techniques such as the capitalisation of discounted cash flows and excess of profits and capitalisation of earnings multiples approaches could provide measurements that are reliable, depending upon the quality and availability of entity-specific information.

164. A number of the interviewees, particularly those from the large accounting firms, expressed a view that the fair value of an internally generated intangible asset cannot be reliably measured when identifiable cash flows cannot be directly attributed to the intangible asset, or the intangible asset is in an early stage of development. They suggested that historical cost could be used as an upper limit for the purposes of measurement, or else a proxy for replacement cost. However, other interviewees, also from the large accounting firms, noted that the amount an entity can spend on developing an intangible asset is largely speculative and therefore is unlikely to reflect the amount the entity would spend to reconstruct the asset, or what another entity would be willing to spend to acquire it. They acknowledged, however, that historical cost (and replacement cost) could provide a reasonable 'cross check' or 'reality check' against other measures. Although SFAS 157 anticipates valuation techniques consistent with the market approach, income approach, and/or cost approach (see paragraph 18 of SFAS 157), it is apparent that a cost approach would only be appropriate if the criteria in Level 3 are

satisfied. Therefore, capitalisation of historical costs is unlikely to be an acceptable technique for determining fair value on initial recognition of internally generated intangible assets.

Perspectives of Users of Financial Reports

165. Where fair values are provided in financial reports, there appears to be healthy scepticism amongst financial analysts about the veracity of those values.

166. In their survey of the views of European professional investors and their advisors, Gassen and Schwedler[33] note that:

> *respondents clearly differentiate between mark-to-model and mark-to-market concepts when evaluating the decision-usefulness of fair values.* For most asset classes, they rank mark-to-model fair values as the least decision-useful measures. (page 16)

Their reference to "most asset classes" explicitly includes intangible assets.

167. The financial analysts interviewed by us commented that, where fair values of intangible assets are provided in financial reports, they should be determined by an independent valuer and supported by disclosure of information about the measurement model adopted, together with key assumptions and sensitivities. We consider issues relating to disclosures in Chapter 5 of this Paper.

168. In its survey, PricewaterhouseCoopers (2007) found pervasive concerns about the adoption of any form of current value measurement for illiquid assets, including intangible assets. Many of the PricewaterhouseCoopers interviewees questioned management's ability to provide reliable estimates of current value (and expressed concern about the potential for changes in current value estimates to mask operating performance, given the current presentation of the income statement – an issue that is the subject of the IASB's Financial Statement Presentation project). It appears that many analysts view the task of estimating the current value of various assets and liabilities (both on and off balance sheet) in determining the value of an entity as part of their role, not the role of management or accountants. They believe that they can better ascribe a value to intangible assets than

33 Gassen, J. and Schwedler, K. (2008). 'Survey: The View of European Professional Investors and their Advisors – Attitudes towards Fair Value and Other Measurement Concepts: An Evaluation of their Decision-usefulness', Accounting Standards Committee of Germany, Berlin, April.

management and, if management were to attempt to put a market value on an asset, it would usurp the market's role of valuing assets.

169. An independent valuation expert interviewed by us commented that, although a broad level of valuation knowledge and experience may not currently exist throughout the world, which perhaps leads to concerns about the veracity of values, this is a consequence of there being no current requirement for the determination of fair value. He observes that, if fair value were to be prescribed for the financial reporting of internally generated intangible assets, the skills would develop and spread from those jurisdictions where the skill base lies. He believes that the fair value of the vast majority of internally generated intangible assets can be determined reliably for external financial reporting purposes. Some note that because valuation knowledge tends to be in the marketing and strategy areas and not mainstream valuation, their views might not carry weight now, but they will provide a useful reference point as ideas develop.

170. We note that concerns about reliable measurement of internally generated intangible assets arise in relation to both a cost model and a fair value model. In relation to fair value, we note that concerns about measurement should be alleviated with the advent of greater consistency in the valuations. Some argue that fair value measurement should not be contemplated until greater consistency is achieved. However, consistent with our comments in paragraph 169 of this Paper, the imposition of measurement requirements may itself facilitate greater consistency as the requirements lead to a focus on developing credible techniques. Such developments are emerging, as is evident from the activities of the FASB, American Institute of Certified Public Accountants (AICPA), The Appraisal Foundation (TAF) and International Valuation Standards Committee (IVSC). For example:

(a) in June 2007, the AICPA issued Statement on Standards for Valuation Services No. 1 *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*;

(b) the FASB is assessing whether, and to what extent, additional and more specific valuation guidance is needed for financial reporting purposes beyond the guidance in SFAS 157. As part of this, the FASB solicits the views of its constituents through a valuation resource group that provides the FASB staff with information on existing implementation issues on fair value measurements;

(c) the IVSC has established a team of experts (comprising valuation and accounting experts) to draft a valuation standard

and implementation guidance to address measuring the fair value of intangible assets, such as brands, licences, patents, know-how, customer contracts and customer relationships. As a first step, in July 2007 the IVSC released a Discussion Paper *Determination of Fair Value of Intangible Assets for IFRS Reporting Purposes* for comment. The IVSC has received comments on the Discussion Paper and conducted a roundtable in May 2008. The IVSC Standards Board is proceeding to develop the following Exposure Drafts:

(i) a revised Guidance Note 4 *Valuation of Intangible Assets*;

(ii) new guidance on the Valuation of Intangible Assets under IFRS; and

(iii) a Technical Paper discussing intangible asset valuation methods with worked examples;[34] and

(d) TAF[35] has published a Discussion Draft (10 June 2008) *Best Practices for Valuations in Financial Reporting: Intangible Assets Working Group – The Identification of Contributory Assets and the Calculation of Economic Rents*. The Draft is a precursor to an Exposure Draft of a proposed Best Practices document. Paragraph 5.1.01 states:

> Intangible assets are often valued utilizing an income approach. Within the income approach, the Multi Period Excess Earnings Method, or, MPEEM, has arisen as a commonly applied methodology. Estimates of Contributory Asset Charges (CACs) are necessary to properly employ the MPEEM. Many implementation issues arise in calculating CACs, such as: contributory asset identification, application of an appropriate methodology, stratification of discount rates, etc. This document seeks to highlight these issues, present various views, and ask questions for respondents to gather input in advance of issuing a formal exposure draft of a best practices document.

In any event, there is precedent for standard-setters proposing principle-based requirements ahead of developments in implementation guidance. For example, the IASB is advocating use

34 IVSC *E-News*, Issue 9, January 2007, Issue 16, August 2007; Issue 20, January 2008; and Issue 22, August 2008.

35 The Appraisal Foundation is authorised by the US Congress as the source of appraisal standards and appraiser qualifications.

of market value margins in its Insurance Contracts project, but does not yet know how they will be determined – potentially leaving it to actuaries to develop appropriate techniques.

Conclusion

171. *We conclude that, if a valuation-based model were adopted, internally generated intangible assets are capable of being reliably measured at fair value to the same degree that the IFRS 3 presumption (that the fair value of the same types of intangible assets acquired in a business combination is capable of reliable measurement) is valid. Subject to the outcome of the IASB/FASB Fair Value Measurement project, SFAS 157 provides a possible basis for specifying the determination of fair value of internally generated intangible assets. Until then, IFRS 3 provides an adequate basis.*

172. In the remainder of this Chapter we consider the relative merits of cost and fair value as the basis for measuring internally generated intangible assets.

SHOULD INTERNALLY GENERATED INTANGIBLE ASSETS BE MEASURED AT COST OR FAIR VALUE?

173. The IASB has not yet resolved the more general question of measurement at a conceptual level. Accordingly, in the following, we consider whether internally generated intangible assets should be measured at cost or fair value in the context of the existing literature and recent debate on the topic.

Arguments For and Against Allowing a Choice between Cost and Fair Value

174. Some argue that it is not necessary to answer the cost/fair value question for internally generated intangible assets, even at a standards-level, because internally generated intangible assets can be accounted for within the general principles of the *Framework* at either cost or fair value, as demonstrated in this Paper. Furthermore, they argue that the existing suite of IASB standards allows a choice between cost and fair value for many classes of assets (particularly for subsequent measurement) and that choice should also be available for internally generated intangible assets until it is reviewed for all types of assets.

175. However, retaining the choice between cost and fair value has greater implications in the context of internally generated intangible assets than for most other asset classes given the number and significance of internally generated intangible assets that do not have attributable costs. Therefore, there is a potential for the absence of a specified

measurement basis to give rise to an even greater lack of comparability than is the case for other asset classes.

Arguments For and Against Cost

176. Arguments in favour of initially measuring internally generated intangible assets at cost rather than fair value include that it is more consistent with the treatment of internally generated tangible assets (property, plant and equipment). Furthermore, some argue that it is more consistent with IFRS 3 principles because IFRS 3 uses fair value merely as a surrogate for cost (see for example paragraph 33 of IAS 38), despite the fact that IFRS 3 potentially results in day-one gains relating to a bargain purchase.

177. Some argue that another benefit of a cost-based model is that, compared with a valuation-based model, it is closer to the current requirements in IAS 38. Furthermore, it generally provides a cost-effective way of measuring internally generated intangible assets and relies on traditional recognition triggers (incurrence of cost), rather than effectively using reporting date as a recognition trigger. Subsequently, subjecting those assets to impairment testing only where impairment is indicated is also more cost-effective than a valuation-based model. However, it runs a greater risk that the carrying amounts of internally generated intangible assets exceed their recoverable amounts.

178. Under a traditional view of a cost-based model, unplanned internally generated intangible assets would not be recognised. A consequence of this is that it may provide an incentive for an entity to inappropriately contrive planned or unplanned assets to suit the entity's, rather than users', financial reporting interests. As we noted in paragraph 43 of this Paper, the degree to which planned assets are identified is determined by the foresight of management and the quality of the accounting system.

179. To overcome concern about the traditional view of a cost-based model failing to recognise unplanned internally generated intangible assets, some argue that a modified view of a cost-based model should be adopted, under which: (a) unplanned internally generated intangible assets are initially measured at fair value as a surrogate for cost; and (b) planned internally generated intangible assets are initially measured at cost. This approach may have some merit. It results in the identification and recognition of both planned and unplanned internally generated intangible assets. Although more onerous from a preparer's perspective than the traditional view of a cost-based model, it is not as onerous as adopting the valuation-based model for both planned and unplanned internally generated intangible assets.

Furthermore, it more clearly distinguishes initial measurement from ongoing measurement and is arguably consistent with IFRS 3 principles. In relation to planned internally generated intangible assets, it is consistent with the treatment of internally generated tangible assets reflected in IAS 16. In relation to unplanned internally generated intangible assets, it is consistent with the IASB's treatment of financial assets acquired at no cost (see paragraph 43 of IAS 39 *Financial Instruments: Recognition and Measurement*) and discovery-value accounting (see paragraph 121 of this Paper). However, like the traditional view of a cost-based model, it can be criticised for treating planned and unplanned internally generated intangible assets differently. Also, it does not overcome the fundamental difficulties of deciding when to initially recognise unplanned internally generated intangible assets, and when cost accumulation starts and ends for planned internally generated intangible assets.

Arguments For and Against Fair Value

180. Arguments in favour of measuring internally generated intangible assets at fair value rather than cost include that it provides more relevant information and results in a consistent treatment of the same kind of assets acquired in a business combination under IFRS 3. It does not necessarily imply anything about subsequent measurement as it is consistent with discovery-value accounting (see paragraph 121 of this Paper). An amount determined under Levels 1, 2 or 3 of the fair value measurement hierarchy as described in SFAS 157 was overwhelmingly preferred over cost by most preparers or their advisors interviewed for the purpose of this Paper on the basis of their experience and because it provides relevant information by capturing the expectations of future cash flows generated by an asset. In contrast, historical cost would only coincidentally capture the future economic benefits attributable to an internally generated intangible asset.

181. However, some individuals interviewed by us noted that a requirement for internally generated intangible assets to be measured at fair value gives rise to particular audit issues. The work involved in reliably determining fair value could affect the ability of entities to report on a timely basis. They also argue that fair value measurement is difficult to justify on cost-benefit grounds. They assert that the costs of identifying, measuring and auditing intangible assets under the current standard are acceptable. Making the requirements more onerous would unduly increase compliance and audit costs. However, we note that, although audit and other costs may be relatively low under the current regime, so too are the benefits provided from the resulting lack of information.

182. Some are concerned that, under a valuation-based model, in the absence of any other 'trigger' or 'control point', the only 'trigger' for recognising an internally generated intangible asset is a reporting date. In response, we note that the *Framework* does not identify the absence of an attributable transaction as a justification for non-recognition of an asset. Some accept that fair value measurement may be suitable, although onerous, for the initial measurement of a planned internally generated intangible asset on completion or abandonment of a project or an unplanned internally generated intangible asset. However, if planned internally generated intangible assets that are work in process were to be required to be valued at fair value at each reporting date, this would be particularly onerous from a preparer's perspective. They argue that at least a cost-based approach to measurement of the work-in-process asset should be adopted. We acknowledge that there is pragmatic merit in this view, although we find it difficult to justify on conceptual technical grounds.

183. Some are concerned that the subjectivity involved in identifying, recognising and measuring internally generated intangible assets at fair value exposes financial reporting to a high degree of manipulation. However, we note that it would be difficult, if not impossible, to write an accounting standard that prevents the manipulation of accounting numbers.

184. Australian financial analysts interviewed by us for the purpose of this Paper expressed a view that, given their focus on cash flows, fair value measurement of internally generated intangible assets (and, for that matter, intangible assets acquired in business combinations) for financial reporting purposes is unnecessary. Consistent with the findings of PricewaterhouseCoopers (2007) as we noted in paragraph 168 of this Paper, financial analysts see their role as determining value and therefore a fair value asserted by an entity's management is not particularly helpful. Although it was acknowledged that it can be useful as a point of comparison, some financial analysts questioned whether the benefits outweighed the costs incurred by the entity in determining fair value. They expressed concern that fair values can be misleading to the extent there is a lack of consistency in the measurement methods adopted, leading to lack of comparability.

185. On the question of the suitability of applying the principles for the recognition and measurement of intangible assets acquired in a business combination to internally generated intangible assets, the views of the Canadian Users Advisory Committee (UAC) members were mixed. Some expressed concerns about the absence of an arm's length transaction for internally generated intangible assets, leaving no basis for determining objective value other than development cost, and

thought that benefits would not outweigh the costs of preparation and audit. One investor expressed a view that the principles would be appropriate for identification of internally generated intangible assets but not for measurement purposes. Others expressed a view that, given the increased significance of internally generated intangible assets, the appropriateness of ascribing fair valuation is self-evident. The buy-side analyst commented that, if an entity has made the effort to secure contractual or legal rights in relation to an intangible asset, then the value of any income stream associated with those rights should be considered part of its asset base. An investor commented that recognition of internally generated intangible assets would allow analysts to perform valuations on the break-up value of an entity.

186. We note that the views we have been able to ascertain and that are outlined above are from those users who are organised in such a way as to be able to convey their views to standard-setters. They are at the relatively highly sophisticated end of the spectrum of users of financial reports identified in the *Framework*.

187. Although the views of relatively highly sophisticated users provide important input to the debate, other, relatively unsophisticated, users might hold a different view. For example, there may be a significant number of users who are interested in management's assessment of current values being recognised. It is difficult to ascertain the views of such a disparate group. Nevertheless, whilst heeding the views expressed by relatively highly sophisticated users, the standard-setter arguably has a responsibility to ensure that the interests of relatively unsophisticated users are also considered. Therefore, standard-setters may need to stand in the place of these users and decide on what is in their interests, using the *Framework* as the basis for decisions. This approach would be particularly valid to the extent that the *Framework* is developed having regard to the needs of both relatively highly sophisticated and unsophisticated users. Any conclusion on this matter should have regard to the view that additional information about intangible assets may increase the complexity of financial statements to the detriment of relatively unsophisticated users.

188. We note that users' views are rarely consistent and their diversity can be used to justify any one of a range of potential conclusions. Users and management might have incentives, depending on their particular circumstances, to favour one possible approach to internally generated intangible assets over another possible approach, regardless of the conceptual basis for the approach. For example:

(a) some might support not recognising internally generated intangible assets despite the conceptual merits of recognition because:

(i) greater transparency in the accounting for intangible assets would potentially undermine the competitive advantage that:

(A) some entities presently derive from unrecognised and undisclosed (secret) intangible assets that, if revealed in the financial report, would cease to provide the level of benefits that would otherwise be expected; and

(B) some analysts and valuers presently derive from their proprietary models developed to address inadequacies in the current financial reporting model; and

(ii) they are concerned about volatility of profits; and

(b) some might support recognising internally generated intangible assets despite the conceptual merits of non-recognition because recognition would enhance the apparent strength of the statement of financial position.

189. In this Paper we have sought to identify conceptually sound conclusions, having regard to practical considerations. In doing so, we acknowledge that the motives noted above are potential impediments to achieving the objectives underlying our conclusions.

Conclusion

190. *From a technical conceptual perspective, we conclude that internally generated intangible assets should be required to be initially measured at fair value to enhance the decision-usefulness of financial reports. An option to adopt cost as an alternative to fair value should not be allowed. On balance, we also think that this view can be justified on practical grounds. However, we acknowledge the views of some against our conclusion. Accordingly, before our conclusion is considered for implementation, we think that further investigation of the perceived practical impediments is warranted.*

191. Some of the practical aspects of measuring internally generated intangible assets at fair value that we think would need to be considered include:

(a) the level of valuer expertise that would be warranted;

(b) whether goodwill can be separated from identifiable intangible assets in a reliable way using a hypothetical business combination methodology; and

(c) the problems that preparers of financial statements might experience in applying a hypothetical business combination method.

Implications for Current Requirements

192. Our conclusion in paragraph 190 is significantly different from the current requirements for measurement of internally generated intangible assets in IAS 38. Therefore, implementation of our conclusion would involve a number of substantial amendments to the requirements in IAS 38, particularly paragraphs 18-24, to require internally generated intangible assets to be recognised initially at fair value.

CHAPTER 5 – PRESENTATION/DISCLOSURE

INTRODUCTION

193. In Chapter 4 we considered the arguments for and against the initial measurement of internally generated intangible assets at either cost or fair value and concluded that internally generated intangible assets should be initially measured at fair value. While this conclusion might otherwise be regarded as a constraint over the scope of this Chapter, in this Chapter we consider presentation and disclosure issues within both a cost-based model and a fair value model. In particular, in this Chapter we consider:

    (a) the implications of the current broad presentation and disclosure requirements in IAS 1 being applied to recognised internally generated intangible assets;

    (b) whether presentation and disclosure requirements in addition to those in IAS 1 should be prescribed for recognised internally generated intangible assets; and

    (c) disclosures to supplement the non-recognition of any internally generated intangible assets that fail to satisfy the relevant recognition criteria.

194. In addressing (b) and (c) above, we consider the suitability of applying the presentation and disclosure principles in IAS 38 and IFRS 3 (that are applicable to intangible assets acquired in a business combination) to internally generated intangible assets. In addition, we consider the suitability of presentation and disclosure principles in other accounting standards that may be pertinent, by analogy, to internally generated intangible assets, including IAS 16, IAS 40 *Investment Property*, IFRS 6 *Exploration for and Evaluation of Mineral Resources*, IFRS 7 *Financial Instruments: Disclosures* and SFAS 157.

195. The main presentation and disclosure requirements in relation to intangible assets currently in IAS 38 (paragraphs 118 and 120-125) predominantly apply to either intangible assets subsequent to their initial recognition or to intangible assets acquired by way of a government grant.[36] As both of these topics are beyond our scope (see paragraphs 7-11 of this Paper), we focus on the requirements in IAS 38 to the extent they are relevant to the presentation and disclosure of internally generated intangible assets in the financial

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36 We consider the applicability of the requirements in paragraph 119 of IAS 38 to internally generated intangible assets in paragraphs 208 and 209 of this Paper.

statements in which such assets would be first recognised or considered for disclosure.

196. For completeness, in this Chapter we also consider the merits of a disclosure-only reporting approach. It is relevant to note that the support for a disclosure-only reporting approach may vary, depending upon whether it is regarded as a preferred alternative to recognition or as an interim step towards a recognition-based reporting approach.

PRESENTATION AND DISCLOSURE IN ACCORDANCE WITH IAS 1

197. Many of the reporting requirements in relation to assets in IAS 1 are sufficient to facilitate presentation of internally generated intangible assets without the need for amendment. For instance, paragraph 54(c) of IAS 1 requires, as a minimum, the presentation of intangible assets as a line item in the statement of financial position. In addition, paragraphs 55, 57 and 58 state that:

> An entity shall present additional line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.
>
> This Standard does not prescribe the order or format in which an entity presents items. Paragraph 54 simply lists items that are sufficiently different in nature or function to warrant separate presentation in the statement of financial position. In addition:
>
> (a) line items are included when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position; and
>
> (b) the descriptions used and the ordering of items or aggregation of similar items may be amended according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity's financial position…
>
> An entity makes the judgement about whether to present additional items separately on the basis of an assessment of:
>
> (a) the nature and liquidity of assets;
>
> (b) the function of assets within the entity…

198. On its own, presentation of an internally generated intangible asset in the statement of financial position is arguably not sufficient to ensure that financial statements provide enough information for users. Paragraph 21 of the *Framework* alludes to this when it states that:

> Financial reports also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement….

199. Sub-paragraph 112(c) of IAS 1 clarifies that the notes shall:

> …provide additional information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

200. In addition, IAS 1 currently requires entities to disclose information in relation to the accounting policies adopted and judgements made by management that would assist users in understanding the entity's reported financial position and financial performance. For instance, paragraph 122 of IAS 1 states that:

> An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Accordingly, the financial statements in which an entity recognises an internally generated intangible asset might disclose, for instance, how the entity will maintain control over the benefits that management expect to flow from the asset.

Interviewees' perspectives

201. While the majority of preparers we spoke to for the purpose of this Paper preferred that intangible assets be presented in the statement of financial position, some indicated that they were reticent to use the descriptor 'intangible assets' due to adverse market and/or regulator reactions to that term. For instance, one preparer indicated that his organisation is reticent to describe items as 'intangible assets' in its financial statements because it had experienced adverse market reactions when that descriptor had been used in the past. Accordingly, the entity uses alternative descriptors, such as 'service concessions', that do not generate the same adverse reactions as the term 'intangible assets' but adequately describe the nature of the item.

202. Paragraph 57(b) of IAS 1 permits an entity to amend the descriptions used for items presented in its financial statements, provided that such amendments facilitate the provision of more relevant information about, for instance, the entity's operations and/or financial position. As we noted in paragraph 37 of this Paper, to facilitate the provision of useful information to users, the descriptor ascribed to an internally generated intangible asset should depict the item's economic phenomena and be meaningful in its commonly understood way. Accordingly, an entity could describe an intangible asset as, for instance, a service concession, provided that this descriptor is appropriate having regard to the prevailing facts and circumstances. In addition, it is relevant to note that paragraph 119 of IAS 38 and the Illustrative Examples to IFRS 3 provide descriptors that a user might expect an entity to adopt, as appropriate, when presenting intangible assets.

Conclusion

203. *We conclude that the current reporting requirements in IAS 1 can be applied to internally generated intangible assets, and are sufficient to facilitate the:*

(a) separate presentation of internally generated intangible assets that are recognised; and

(b) disclosure of information in relation to the accounting policies adopted and judgements made by management in relation to internally generated intangible assets equivalent to the information that is required to be disclosed about other types of assets.

204. Notwithstanding the above conclusion, we consider that, in some circumstances, the application of the requirements in IAS 1 to internally generated intangible assets may not necessarily facilitate the provision of sufficient information to users. Accordingly, the following two sections consider additional presentation and disclosure issues that would arise under either a cost-based model or a fair value model.

PRESENTATION/DISCLOSURE UNDER A COST-BASED MODEL

205. Current IASB standards that address presentation and/or disclosure issues that may be pertinent, by analogy, to internally generated intangible assets measured in accordance with a cost-based model include IAS 38, IAS 16 and IFRS 6. In this section we consider the merits of applying the principles in these standards to internally

generated intangible assets. We do not fundamentally question the merits of the disclosure requirements of these standards.

Descriptors for internally generated intangible assets

206. As we discussed in paragraphs 75-87 of this Paper, under a cost-based model, where an asset exists, the appropriate treatment is to capitalise the costs from commencement of implementing the plan to create the asset up until completion or abandonment of the plan. Therefore, consistent with paragraph 48 of this Paper, an interim asset in the nature of an in-process asset may exist before the asset being developed exists. Consequently, the question arises as to how, for instance, a brand name that is work in process should be presented in the balance sheet. For example, should it be presented as 'Capitalised Brand Development Costs' or 'Brand – Work in Process'? The former descriptor emphasises the capitalised nature of the item and suggests nothing about the future of the project, whereas the latter possibly implies that the costs will eventually be reclassified to a completed intangible asset.

207. Consistent with our comments in paragraph 37 of this Paper, due to the different ways in which entities structure and manage their projects and the different objectives they aim to achieve, the appropriate descriptor for an item can only be determined on an item-by-item/asset-by-asset basis having regard to the prevailing facts and circumstances. Nevertheless, as we noted in paragraphs 35-37, the descriptor adopted for the purpose of financial reporting should depict the item's economic phenomena and be meaningful in its commonly understood way. To this end, descriptors such as 'In-process Research and/or Development' and 'Brand – Work in Process' are preferable to descriptors such as 'Capitalised Research and/or Development Costs' or 'Capitalised Brand Development Costs' for the purpose of presentation of internally generated intangible assets. This is on the basis that the former descriptors more clearly convey the expectation of economic benefits in the future from a completed asset.

208. The presumption that the descriptor adopted for the purpose of financial reporting should depict the item's economic phenomena and be meaningful in its commonly understood way is consistent with the approach currently adopted in IAS 38. For instance, paragraph 119 of IAS 38 states that:

> A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. Examples of separate classes may include:
>
> (a) brand names;

(b) mastheads and publishing titles;

(c) computer software;

(d) licences and franchises;

(e) copyrights, patents and other industrial property rights, service and operating rights;

(f) recipes, formulae, models, designs and prototypes; and

(g) intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.

209. In paragraph 66 of this Paper we concluded that the principles and guidance for identifying the existence of and describing an intangible asset acquired in a business combination specified in IAS 38 and IFRS 3 could be adopted for assessing whether internally generated intangible assets exist. Accordingly, we think that the guidance for describing an intangible asset acquired in a business combination specified in paragraph 119 of IAS 38 (and the guidance provided in paragraphs IE16-IE44 of the Illustrative Examples to IFRS 3) could also be adopted for determining appropriate descriptors for internally generated intangible assets.

Disclosure of cost-based information

210. Consistent with paragraphs 130 and 131 of this Paper, if a cost-based model is adopted, the disclosure principles for other types of assets measured in accordance with a cost-based model could be adopted for internally generated intangible assets. IAS 16 contains pertinent principles/guidance that may be relevant to internally generated intangible assets. For example, in relation to self-constructed property, plant and equipment, sub-paragraph 74(b) of IAS 16 states that the financial statements shall disclose:

> …the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction.

211. As we noted in paragraph 49 of this Paper, a single project could give rise to a number of separate identifiable internally generated intangible assets. Furthermore, some of these assets may not have been anticipated at the commencement of the project. In turn, this may cause the interim and ultimate unit of account to change over the

course of the project. In light of this, if a cost-based model is adopted, consistent with requirements in IAS 16, the amount of expenditures incurred during a reporting period reliably attributable to each originally or subsequently planned asset should be disclosed, to ensure users are informed of the intangible asset generating activities of the entity.

212. IAS 38 does not require entities to disclose the basis on which management concluded that a recognised internally generated intangible asset fulfilled the relevant recognition criteria. However, a number of financial analysts who we interviewed noted that management's rationale for capitalisation is useful information.

213. It is relevant to note that IFRS 6, which deals with accounting practices for assets that are arguably analogous to capitalised research and development costs, requires entities to provide additional information in relation to exploration and evaluation assets recognised in the financial statements. Paragraph 23 and sub-paragraph 24(a) of IFRS 6 state that:

> An entity shall disclose information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources.
>
> To comply with paragraph 23, an entity shall disclose:
>
> (a) its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets…

Conclusion

214. *We conclude that, if a cost-based model is adopted, the amount of costs incurred in a reporting period and recognised in the carrying amounts of internally generated intangible assets presented in the financial statements should be disclosed together with the accounting policies adopted. In response to users' comments, management's rationale for capitalisation should also be disclosed.*

Implications for current requirements

215. Implementation of our conclusion would require a number of amendments to the disclosure requirements in IAS 38, particularly paragraphs 118-123 and 126-127.

PRESENTATION/DISCLOSURE UNDER A VALUATION-BASED MODEL

216. Current IASB standards that address presentation and/or disclosure issues that may be pertinent, by analogy, to internally generated intangible assets measured at fair value include IAS 16, IAS 38, IAS 40, IFRS 7 and SFAS 157. In this section we consider the merits of applying the principles underlying the disclosures required by these standards to internally generated intangible assets, without fundamentally questioning the merits of those disclosures.

Descriptors for internally generated intangible assets

217. As under the cost-based model, the descriptor adopted for the purpose of financial reporting should depict the item's economic phenomena and be meaningful in its commonly understood way. Accordingly, descriptors that include the term 'capitalised' would be inappropriate for the purpose of presentation of internally generated intangible assets in a fair value model because 'capitalised' is a cost-based term. Consistent with our discussion in paragraphs 206-209 of this Paper, the guidance for describing an intangible asset acquired in a business combination specified in IAS 38 and IFRS 3 could be adopted for determining appropriate descriptors.

Disclosure of the basis of fair value measurement

218. Neither IAS 38 nor IFRS 3 specifically require acquirers to disclose the basis on which they determine the fair values of identifiable assets acquired in a business combination. Therefore, the level of disclosures in relation to fair value measurements required by IAS 38 and IFRS 3 are markedly less onerous than equivalent disclosure requirements in other relevant IASB standards that contain pertinent principles and/or guidance, such as IAS 16 and IAS 40. For instance, paragraph 77 of IAS 16 states that:

> If items of property, plant and equipment are stated at revalued amounts, the following shall be disclosed:
>
> (a) the effective date of the revaluation;
>
> (b) whether an independent valuer was involved;
>
> (c) the methods and significant assumptions applied in estimating the items' fair values;
>
> (d) the extent to which the items' fair values were determined directly by reference to observable prices in an active market

> or recent market transactions on arm's length terms or were estimated using other valuation techniques…

219. Similarly, sub-paragraphs 75(d) and (e) of IAS 40 require an entity to disclose:

> the methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily based on other factors (which the entity shall disclose) because of the nature of the property and lack of comparable market data.
>
> the extent to which the fair value of investment property (as measured or disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued. If there has been no such valuation, that fact shall be disclosed.

220. It is relevant to note that the requirements in IAS 16 and IAS 40 are consistent with recent recommendations made by the CFA Institute (2007) regarding the disclosure of principles used for measuring intangible assets for the purpose of financial reporting. For instance, in outlining investor needs generally, the CFA Institute recommends that managers disclose:

> …the principles used for recognition and measurement of intangible assets recorded in the financial statements. (page 53)

221. It is also relevant to note that the requirements in IAS 16 and IAS 40 are consistent with disclosure requirements in SFAS 157. SFAS 157 requires, amongst other things, the disclosure of information that enables users to assess the inputs used to measure assets at fair value, either on a recurring or non-recurring basis. For instance, in relation to assets measured at fair value on a non-recurring basis, sub-paragraphs 33(b) and (c) of SFAS 157 state that the following disclosures should be made:

> The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets…(Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3)

> For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs…

222. As we noted in paragraph 165 of this Paper, where fair values are provided in financial statements, there appears to be healthy scepticism amongst financial analysts regarding the veracity of those values. Accordingly, the financial analysts interviewed by us suggested that, where fair values are provided, they should be supported by the disclosure of information about the measurement model adopted, together with key assumptions and sensitivities. They considered this would improve the transparency of financial statements and permit users to make more informed decisions regarding management's assumptions.

223. Similarly, the respondents interviewed by PricewaterhouseCoopers (2007, p.6) indicated that, if an asset is to be measured at a current value, the entity should be required to, amongst other things:

    (a) disclose the key assumptions/drivers underlying the current measurements to facilitate comparisons across entities and evaluations of sensitivities and reasonableness; and

    (b) disclose ranges of outcomes rather than point estimates.

224. As we noted in paragraph 200 of this Paper, paragraph 122 of IAS 1 currently requires entities to disclose information in relation to the accounting policies adopted and judgements made by management that would assist users in understanding the entity's reported financial position and financial performance. Equivalent disclosure principles appear to underlie sub-paragraph 27(c) of IFRS 7, which states, in part, that:

> An entity shall disclose … whether the fair values recognised or disclosed in the financial report are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (i.e. without modification or repackaging) and not based on available observable market data. For fair values that are recognised in the financial report, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the entity shall state this fact and disclose the effect of those changes.

Conclusion

225. *We conclude that, if an internally generated intangible asset is measured at fair value, the methods and significant assumptions applied in determining the asset's fair value, including the extent to which the asset's fair value was determined directly by reference to observable prices or was estimated using other measurement techniques, should be disclosed. In addition, if changing one or more of the assumptions used to determine the fair value to reasonably possible alternative assumptions would change the fair value significantly, the entity should state this fact and disclose the effect of those changes.*

226. Information relating to the methods and significant assumptions applied in determining the fair value of an internally generated intangible asset could include:

(a) the effective date of the measurement; and

(b) whether an independent valuer was involved in determining the fair value measurement.

Implications for current requirements

227. Implementation of our conclusion would require a number of amendments to the disclosure requirements in IAS 38, particularly paragraphs 118-123.

Disclosures of alternative measures

228. As we noted in paragraph 195 above, this Chapter focuses on presentation and disclosure of internally generated intangible assets in the financial statements in which they are first recognised or considered for disclosure. Because current accounting standards generally address disclosures of alternative measures in a revaluation context, the disclosure of alternative measures might otherwise not be regarded as an appropriate topic for this Chapter. Nevertheless, we think that it is useful to consider the implications of disclosing alternative measures of internally generated intangible assets at the same time that they are initially recognised at fair value.

229. Sub-paragraph 77(e) of IAS 16 requires the following to be disclosed:

> …for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model…

Consistent with this, in relation to intangible assets measured after recognition using the revaluation model, sub-paragraph 124(a)(iii) of IAS 38 requires entities to disclose:

> …the carrying amount that would have been recognised had the revalued class of intangible assets been measured after recognition using the cost model in paragraph 74.

230. While some argue that the disclosure of alternative measures for items recognised in the financial statements could mislead or confuse users, it is evident from the current disclosure requirements in IAS 16 and IAS 38 that this is not anticipated in relation to internally generated tangible assets or intangible assets separately acquired or acquired in business combinations. All assets have the same fundamental characteristics as identified in paragraph 49(a) of the *Framework*. Accordingly, it would seem reasonable to assume that users would regard information in relation to the cost of developing an internally generated intangible asset as useful for similar reasons as they would regard information in relation to the cost of developing an internally generated tangible asset as useful, or the cost of intangible assets measured using the revaluation model in IAS 38 as useful.

Interviewees' perspectives

231. The users (financial analysts) interviewed by us noted that their principal focus in relation to internally generated intangible assets is on cash flows, primarily for the purpose of assessing value. Accordingly, the users indicated that, irrespective of the measurement method used for intangible assets, they would prefer entities to disclose costs in relation to intangible assets, distinguishing between capital/expansionary costs and operating/maintenance costs, whether on an aggregate or on a project-by-project basis. The users also noted that it is currently unclear from financial statements how much management has spent on particular intangible assets or intangible assets generally because 'bad outcomes' are obscured by being written off to the profit or loss and are not generally disclosed.

Conclusion

232. *We conclude that, in response to users' comments, if internally generated intangible assets are measured at fair value, the costs reliably attributable to an internally generated intangible asset should be disclosed, either on an aggregate or a project-by-project basis.*

Implications for current requirements

233. Implementation of our conclusion would require a number of amendments to the disclosure requirements in IAS 38, particularly paragraphs 118-123.

DISCLOSURES TO SUPPLEMENT NON-RECOGNITION WHERE AN INTERNALLY GENERATED INTANGIBLE ASSET FAILS TO SATISFY THE RELEVANT RECOGNITION CRITERIA

234. Whether information about an item that does not meet the relevant asset recognition criteria is disclosed in the notes to the financial statements may be regarded as a matter for professional judgement in the particular circumstances. For instance, paragraph 21 of the *Framework* states that:

> Financial reports also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement. They may include disclosures about the risks and uncertainties affecting the entity and any resources and obligations not recognised in the balance sheet (such as mineral reserves).

235. A number of interviewees noted that some users appear to treat information disclosed in the notes in the same way that they treat information recognised in the financial statements. While such reactions by users seem to be at odds with the characteristics of items that fail the recognition criteria identified in paragraph 83 of the *Framework*, and contradict studies that found information disclosed as supplementary notes is given relatively less weight by users than information recognised in the financial statements,[37] it may be that some users have little appreciation of the differences between an internally generated intangible item recognised in the financial statements and an equivalent item disclosed in the notes. Alternatively, it may be that some users regard all intangible assets as inherently risky, irrespective of whether they are recognised in the financial statements or disclosed in the notes. Furthermore, arguably because IAS 38 currently prohibits entities from recognising a number of different types of intangible assets, some users have limited access to information in relation to intangible assets and, therefore, may not

37 For instance, as noted in footnote 57 in the Management Commentary Discussion Paper (2005), Sami, H. and Schwartz, B. (1992). 'Alternative pension liability disclosure and the effect on credit evaluation: an experiment', *Behavioral Research in Accounting*, Volume 4, pp.49-62.

discriminate against information about intangible assets disclosed in the notes.

236. In relation to intangible assets acquired in business combinations, sub-paragraph B64(e) of IFRS 3 states that an acquirer shall disclose for each business combination that occurs during the reporting period:

> …a qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors.

This provides some justification for requiring disclosures about unrecognised internally generated intangible assets. However, we acknowledge that some argue that the principles underlying the requirements in sub-paragraph B64(e) of IFRS 3 are only relevant to business combinations and therefore not relevant to internally generated intangible assets. In particular, a description of the intangible assets that do not qualify for separate recognition in a business combination provides users with information useful to understanding the cost of the business combination and some of the components of goodwill. As we observed in paragraph 101(b) of this Paper, this type of rationale is not relevant to the identification of internally generated intangible assets because internally generated goodwill is not recognised.

237. In relation to intangible assets (including internally generated intangible assets) that do not meet the recognition criteria in IAS 38 or were acquired or generated before IAS 38 became effective, sub-paragraph 128(b) of IAS 38 states that:

> An entity is encouraged, but not required, to disclose the following information:
>
> (a) …
>
> (b) a brief description of significant intangible assets controlled by the entity but not recognised as assets...

238. While sub-paragraph B64(e) of IFRS 3 and sub-paragraph 128(b) of IAS 38 appear to be aimed at achieving similar financial reporting outcomes, where relevant, the application of sub-paragraph B64(e) of IFRS 3 is mandatory whereas the application of sub-paragraph 128(b) of IAS 38 is not. However, treating intangible assets differently based upon the manner in which they arise is inconsistent with our conclusions in paragraph 66 of this Paper. Moreover, not requiring an entity to disclose information in relation to a significant intangible

asset that it controls is arguably inconsistent with the financial reporting objective to provide decision-useful information. As we noted in paragraph 235 above, some users appear to treat all financial information about intangible assets as useful, irrespective of whether it is recognised or only included in disclosures in the financial statements.

Interviewees' perspectives

239. A representative from one of the four large accounting firms noted that, while the users of financial statements might welcome note disclosures in relation to internally generated intangible assets that do not fulfil the relevant recognition criteria, reporting entities do not generally share this view. The representative suggested that, if an internally generated intangible asset does not fulfil the recognition criteria, given the choice between disclosing the item in the notes and not disclosing it at all, management and directors would invariably favour the latter course of action. This preference could be attributed to a number of factors, including:

    (a) the unfavourable reactions generally associated with users' unfulfilled expectations in relation to items disclosed in the notes, notwithstanding that the level of uncertainty associated with items disclosed in the notes may be greater than the level of uncertainty associated with items recognised in the financial statements; and

    (b) the general perception amongst managers and directors that information recognised in the financial statements is relatively more useful than information disclosed in the notes.

Conclusion

240. *We conclude that, if an internally generated intangible asset does not meet the relevant recognition criteria, in the interests of providing useful information to users, entities should be required to disclose a description of the asset and the reason why the asset fails to meet the relevant recognition criteria.*

Implications for current requirements

241. Implementation of our conclusion would lead to the disclosure requirements in sub-paragraph 128(b) of IAS 38 being amended so that they are consistent with the requirements in sub-paragraph B64(e) of IFRS 3.

A DISCLOSURE-ONLY REPORTING APPROACH FOR INTERNALLY GENERATED INTANGIBLE ASSETS

242. Given the controversy surrounding the recognition and measurement of internally generated intangible assets, some argue that a disclosure-only approach provides a better means of incorporating into financial statements information about internally generated intangible assets, even if they satisfy the relevant recognition criteria.

243. Some users interviewed by us acknowledged that the recognition of intangible assets at fair value, or even at capitalised cost, might provide useful information. However, they have reservations as to whether this is better than having more disclosures about intangible assets and the other drivers of entity value, to enable investors to better forecast future cash flows.

244. These views are consistent with the findings from other studies. For instance, as noted in paragraph 102(c) above, seventy-four percent of PricewaterhouseCoopers (2007) interviewees described the balance sheet item ‘intangible assets’ as “not useful”. From this, PricewaterhouseCoopers (2007, p.11) concluded that investors are more interested in the nature of, and expenditure on, intangible assets than in the treatment of intangible assets in the financial statements.

245. Some support the disclosure of intangible assets as part of the narrative produced by entities. They note that whilst a disclosure-only approach may not be optimal for some, it would allow entities to communicate the nature of their intangible assets and the uncertainty associated with their measurement more effectively than a single number in the balance sheet.

246. In its letter to the IASB on 1 August 2007, the CRUF[38] notes that:

> … whilst accounting for intangibles is an intellectually interesting debate, devoting valuable resources to moving the debate forward is likely to provide answers to questions that are not being asked by users. The information will not be decision useful. Reporting on intangibles is much more suited to the management commentary than the balance sheet and we are keen to support the Board in its efforts in this area.

247. Some argue that the dissatisfaction expressed by users with the recognition of intangible assets reflects a more fundamental concern with the capacity of the current reporting framework to accommodate

38 IASB and FASB, 2008. *Agenda Paper 5 – Appendix 2 (Observer Note): Corporate Reporting Users’ Forum Briefing Pack*, Joint IASB/FASB Meeting, April, London.

intangible assets, particularly internally generated intangible assets. This argument is premised on the view that intangible assets are fundamentally different from tangible assets. For instance, Lev (2001) observes that, while all investments and assets are risky in an uncertain business environment, the riskiness of intangible assets is, in general, substantially higher than that of physical and financial assets.

> For one, the prospects of a total loss common to many innovative activities, such as a new drug development or an Internet initiative, are very rare for physical or financial assets. Even highly risky physical projects, such as commercial property, rarely end up as a total loss. The huge Canary Wharf project in London, for example, virtually bankrupt in the mid 1990's, revived later and is now considered a commercial success.
>
> A comparative study of the uncertainty associated with R&D and that of property, plant and equipment confirms the large risk differentials: The earnings volatility (a measure of risk) associated with R&D is, on average, three times larger than the earnings volatility associated with physical investment. (page 39)

Accordingly, some of those who argue the current reporting framework is incapable of accommodating intangible assets propose that standard-setters consider the alternative ways in which entities could disclose information in relation to their intangible assets.

248. Disclosure-based reporting approaches appear to be gaining support in some jurisdictions. For instance, the Danish Agency for Trade and Industry[39] proposes that companies should prepare intellectual capital statements, which report on:

> … the company's efforts to obtain, develop, share and anchor the knowledge resources required to ensure future results. The intellectual capital statement can contribute to creating value for the company by improving the basis for growth, flexibility and innovation. Its merits lie in expressing the company's strategy for what it must excel at in order to deliver satisfactory products or services. (page 13)

Nevertheless, the Danish Agency for Trade and Industry (2000) advise that:

39 Danish Agency for Trade and Industry, (2000). *A Guideline for Intellectual Capital Statements – A Key to Knowledge Management*, November, Danish Agency for Trade and Industry, Copenhagen, Denmark (www.euintangibles.net/library/localfiles/ICS-Uksprog.pdf).

> The objective of an intellectual capital statement is not to calculate the value of the company's knowledge in financial terms. Also, this is probably not feasible. Thus, an intellectual capital statement cannot be used to explain the difference between a company's book value and its market value… (page 14)

249. In contrast, others argue that the current reporting framework is more than capable of accommodating intangible assets, including internally generated intangible assets. They comment that note disclosures and supplementary reports are a 'second best' solution to a 'first class' problem. For instance, those interviewed by us from the consumer product corporations expressed concerns with a disclosure-only approach for internally generated intangible assets. They argued that such note disclosures diminish the comparability of their financial statements to the financial statements of other entities, particularly those that have acquired brand names separately or in business combinations. For instance, the preparers from one of the consumer product corporations indicated that the adoption of IAS 38 in Australia meant that the corporation could no longer recognise certain internally generated intangible assets and therefore needed to use note disclosures more extensively. These preparers noted, however, consistent with the importance of the corporation's brand names to its operations, that they would prefer to recognise the corporation's identifiable brand names in the financial statements, irrespective of the manner in which they arise. The preparers from the other consumer product corporation suggested that disclosure in the notes instead of recognition in the financial statements would give rise to a 'second set' of financial statements.

250. Views such as these are consistent with paragraph 82 of the *Framework*, which states that:

> Items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

Similarly, paragraph 18 of IAS 1 states that:

> An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

251. As we discussed in paragraphs 98-100 of this Paper, non-recognition of internally generated intangible assets that satisfy the relevant recognition criteria raises a number of issues, including its inconsistency with the notion of accountability. However, recognition

is not a necessary means of enabling assessment of accountability. Accountability can arguably equally be assessed through disclosures in the notes to financial statements or by other means. However, consistent with the business maxim 'when you measure it, you manage it', recognition is arguably more effective than mere disclosure in facilitating improved management practice. Evidence of this can be found in the reporting practices of entities following the introduction of SFAS 123 *Share-Based Payment*, which illustrate that disclosed amounts are not necessarily always prepared with the same level of robustness as recognised amounts.[40]

252. While a disclosure-only approach may not be an appropriate long-term accounting solution for internally generated intangible assets, some argue that it has merit as an interim step towards a recognition-based accounting solution. For example, the CFA Institute (2007) states that:

> Longer term, we believe that all intangible assets should be recognized at fair value. In the interim, however, we recommend that managers disclose the following:
>
> 1. Estimates of the fair value of identifiable intangibles not recognized in the financial statements. In addition, nonfinancial indicators, such as market size and share and customer retention data, are useful disclosures.
>
> 2. The principles used for recognition and measurement of intangible assets recorded in the financial statements.
>
> 3. Information about intangibles that are imbedded in other tangible or financial assets, such as core deposit intangibles.
>
> 4. The nature of any goodwill recognized and the key variables that would be assessed in impairment tests of the goodwill. (page 53)

253. There are a number of benefits of a disclosure-only approach being applied as an interim step prior to adopting a recognition-based approach for internally generated intangible assets. For instance, it could:

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40 See, for example, Libby, R., Nelson, M.W. and Hunton, J.E. (2006). 'Recognition v. Disclosure, Auditor Tolerance for Misstatement, and the Reliability of Stock-Compensation and Lease Information', *Journal of Accounting Research*, Volume 44, pp. 533-560.

(a) allow entities to become accustomed to the idea of identifying and measuring internally generated intangible assets;

(b) help to alleviate the question of when internally generated intangible assets should be recognised;

(c) provide empirical data about items that would not otherwise be disclosed; and

(d) facilitate the dissemination of information about intangible items that do not meet the definition or recognition criteria for assets, such as knowledge capital and assembled workforce.

Interviewees' perspectives

254. The users (financial analysts) interviewed by us noted that, if all expenditures in relation to intangible assets are disclosed, they do not need expenditures in relation to internally generated intangible assets to be capitalised. However, the majority of the other interviewees expressed significant concerns with the disclosure of information regarding intangible assets in the notes as a substitute for recognition.

255. As we noted in paragraph 249 of this Paper, those interviewed by us from the consumer product corporations argued that note disclosures do not give due prominence to items that corporations regard as critical to their respective operations. Likewise, the preparers from one of the financial services corporations expressed concerns with disclosure in the notes instead of recognition in the financial statements and questioned the usefulness of note disclosures that are predominantly qualitative. The preparers from one of the financial services corporations also indicated that the levels of disclosure and audit risks associated with providing quantitative information in the notes is comparable to the levels of disclosure and audit risks associated with recognising the same information in the financial statements. Consequently, these preparers indicated that they have no reason to prefer disclosure over recognition.

256. An interviewee from one of the accounting firms suggested that users are likely to be more sceptical about the quality of information contained in the notes compared with the information recognised in the financial statements. This interviewee also noted that management and directors generally question the usefulness of information disclosed in notes compared with information recognised in the financial statements, particularly considering the number of assumptions that often underpin note disclosures and the concomitant level of uncertainty associated with these assumptions.

257. Consistent with the views expressed by a number of our other interviewees, an independent valuation expert interviewed by us commented that users tend to heavily discount the usefulness of information disclosed in the notes. Moreover, the interviewee commented that disclosure in the notes, instead of recognition, of intangible assets that satisfy the recognition criteria contradicts the importance management and users place on intangible assets generally and is an inadequate means of ensuring that capital markets are fully informed.

Conclusion

258. *We conclude that, consistent with the recognition and disclosure principles in the Framework and IASB standards, disclosure is not an adequate substitute for recognition and that internally generated intangible items that meet the relevant asset definition and recognition criteria should be recognised in the financial statements. While a disclosure-only approach may have some merit as a pragmatic interim step towards the adoption of a recognition-based accounting approach for internally generated intangible assets, in the interests of maximising the information content of financial statements on a timely basis, we prefer a recognition-based approach.*

Implications for current requirements

259. Our conclusion does not have any additional implications for IAS 38 beyond those we identified in paragraphs 67, 88, 114-115, 135-136 and 192 of this Paper.

APPENDIX A: INTERVIEWS

A1. As we noted in paragraph 25 of this Paper, individuals and organisations with experience in identifying, recognising and measuring (and remeasuring) internally generated intangible assets and using the resulting information were interviewed by us. Fourteen interviews were conducted. Interviewees were people who had experience with Australian Accounting Standards that permitted recognition and measurement (and/or remeasurement) of internally generated intangible assets in a broader range of circumstances than under IFRS 3 *Business Combinations* and IAS 38 *Intangible Assets*[41] in terms of:

(a) preparing financial statements;

(b) valuing intangible assets for inclusion in financial statements;

(c) auditing financial statements; and

(d) using financial statements for decision making.

A2. Appropriate individuals and organisations with relevant experience were identified, in the first instance, through the Australian 'Group of 100'.[42] Interviews were also conducted with Australian representatives of four large accounting firms. The interviewees were assured of confidentiality and therefore views have not been attributed to particular interviewees. We have categorised the interviewees on the following basis for the purposes of this Paper:

(a) large accounting firms;

(b) consumer product corporations;

(c) financial services corporations;

(d) telecommunication and broadcasting corporations;

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41 All the interviewees had experience in the Australian environment when the Accounting Standards contemplated internally generated intangible assets being recognised in a wide range of circumstances and measured on either a cost or fair value basis.

42 The Australian 'Group of 100' represents Australia's senior financial executives from the nation's major private and public business enterprises. The primary goal of the organisation is to ensure that Australia's commercial environment is one that advances the interests of Australian businesses engaged in the competitive global environment (www.group100.com.au).

(e) users of financial reports;[43] and

(f) independent valuation experts.[44]

For the purposes of confidentiality, given the small number of entities in each category, the entities whose management and accounting staff were interviewed by us are not specifically identified.

A3. Representatives of the entities selected were interviewed by us using a series of open-ended questions regarding the participants' experiences with respect to the identification, recognition and measurement (and remeasurement) of intangible assets, particularly internally generated intangible assets. Particular emphasis was placed on the reliability of measurement procedures being employed prior to the adoption of IAS 38 and IFRS 3. Most interviews took between 1 and 1 ½ hours to complete, although a small number of initial interviews lasted for approximately 2 hours.

A4. The following questions (provided to interviewees prior to the interviews) formed the basis of our discussions with interviewees about initial recognition of internally generated assets from the large accounting firms, consumer product corporations, financial services corporations and telecommunications and broadcasting corporations.

(a) What types of internally generated intangible assets has your organisation identified and recognised in the past under Australian Accounting Standards?

(b) Are there other types of internally generated intangible assets that you believe should have been separately identified and recognised?

(c) What are the characteristics of those internally generated intangible assets that you believe should be separately identified and recognised that distinguishes them from other (unrecognised) internally generated intangible assets and internally generated goodwill?

(d) What are the benefits of separately identifying and recognising the types of internally generated intangible assets addressed in questions (a) and (b) above?

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43 Interviewees categorised as 'users of financial reports' were employed as securities and equities analysts.

44 We spoke to two independent valuation experts, both from the same firm.

(e) What measurement techniques have you used for initial recognition of each type of internally generated intangible asset?

We rephrased some questions when interviewing in accordance with an interviewee's specific circumstances. For instance, the question 'What types of internally generated intangible assets has your organisation identified and recognised in the past under Australian Accounting Standards?' was modified to 'What types of internally generated intangible assets have you had experience with in the past under Australian Accounting Standards?' when interviewing representatives of large accounting firms.

A5. The following questions (provided to interviewees prior to the interviews) formed the basis of our discussions with the users of financial reports and independent valuation experts about internally generated intangible assets:

(a) What types of internally generated intangible assets have you encountered prior to the introduction of IFRSs?

(b) What characteristics did those internally generated intangible assets identified in (a) above exhibit that led you to regard them as separately identifiable from internally generated goodwill?

(c) What are the benefits of separately identifying the types of internally generated intangible assets that possess the characteristics identified in (b) above?

(d) For those internally generated intangible assets that you separately measure/value, which of the following measurement/valuation techniques have you used:

(i) quoted prices for identical assets in active markets;

(ii) quoted prices for identical assets in non-active markets;

(iii) quoted prices for similar assets in active markets;

(iv) other observable market inputs such as:

- measures of volatility; and

- inputs derived from or corroborated by other observable market data through correlation, extrapolation or interpolation;

(v) unobservable market inputs, using assumptions that market participants would use in pricing the assets, such as future cash flows; and

(vi) other measurement techniques such as historical or replacement cost?

(e) Are you aware of any new or developing markets for particular types of internally generated intangible assets that might assist you in initially measuring/valuing internally generated intangible assets? If so, what characteristics would a new/developing market need to exhibit for you to regard it as capable of generating reliable prices for measurement/valuation purposes?

We asked all of the users of financial reports and independent valuation experts interviewed to respond to questions (a), (d) and (e), whereas we only asked the independent valuation experts to respond to questions (b) and (c). We did not ask the users of financial reports to respond to questions (b) and (c) because they confirmed that they had no direct involvement in the preparation of the financial reports that they used to value businesses and/or the equity instruments of businesses and their knowledge of specific internally generated intangible assets was, for the purpose of the interviews, limited to disclosures made in published financial reports.

A6. Although our interviews involved a range of entities with diverse experiences regarding intangible assets, albeit within one jurisdiction, many of the interviewees expressed similar views on a number of issues related to internally generated intangible assets, including:

(a) Intangible assets are an important component of business operations and represent an increasing proportion of businesses' assets.

(b) Entities have experience in measuring the fair value[45] of a range of internally generated intangible assets, including

45 The interviews did not focus on the definition of fair value. The Australian Accounting Standards under which the interviewees had experience in recognising internally generated intangible assets defined fair value as "the amount for which an asset could be exchanged … between knowledgeable, willing parties in an arm's length transaction." (paragraph 9.1 of AASB 1041 *Revaluation of Non-Current Assets*).

brand names, mastheads and customer contracts, being those that are protectable/transferable. Some have not been recognised, but could be reliably measured, such as management rights. One comment made was that reliable measurement is not dependent on a transaction, because a transaction represents only one opinion of value at a single point in time.

(c) Reliable measurement is particularly achievable where an internally generated intangible asset has traceable cash flows. Cost is not a good indicator of value, but may be a basis for initial measurement and, subject to impairment, subsequent remeasurement.

(d) The 'relief from royalties' method is the most broadly accepted method in practice amongst preparers, auditors and independent valuation experts for determining a reliable measure of fair value of certain internally generated intangible assets, such as brand names. Users of financial reports, on the other hand, did not express a preference for any particular measurement method. They were more interested in accounting treatments being applied consistently across all intangible assets and/or reporting entities and the methodology adopted. They were also interested in reporting entities disclosing the key assumptions underlying the measurements of intangible assets recognised or disclosed in their financial reports. Users of financial reports also expressed a preference for cash flow information, particularly cash expenditure, whether on an aggregate or project-by-project basis, over asset valuation information.

(e) For some items it can be difficult to ensure that the value attributable to the item excludes value attributable to other phenomena.

(f) Certain items cannot be reliably measured/separated from goodwill, such as the corporate brand and assembled workforce.

(g) Concern about the inconsistencies in the financial reporting treatment of intangible assets acquired in a business combination as compared with internally generated intangible assets. However, there was acknowledgement that a business combination at least provides a strong indication of an upper limit for valuation purposes.

(h) There are practical factors that influence an entity's attitude to recognition and measurement of internally generated intangible assets. For instance, the treatment of some items by domestic regulators (eg the Australian Prudential Regulation Authority); the treatment of some items for tax purposes; the effects of banking covenants; implications for performance reporting; and the desire for prudent measures.

(i) Note disclosure as an alternative to recognition may have some merit or represent a reasonable compromise, however it is difficult to justify conceptually.

We have reflected the results of our interviews as accurately as possible throughout this Paper. The Paper focuses on a critical analysis of the main issues relating to the initial accounting for internally generated intangible assets, rather than a critical analysis and assessment of interviewees' comments.

APPENDIX B:
INSIGHTS FROM ACADEMIC STUDIES

B1. Research by a number of academics indicates that the current requirements in IAS 38 *Intangible Assets* limit the usefulness of financial reports and therefore the needs of users are not being met in the most effective way. In this Appendix we summarise some of the findings of that research.

B2. Barth and Clinch (1999)[46] investigated whether relevance, reliability and timeliness of asset revaluations in Australia prior to the adoption of IFRS in Australia differed across types of assets, including investments, property, plant and equipment, and intangible assets. The study found that revalued amounts in excess of historical cost are value relevant; where 'value relevant' is described as "the amount has a significant relation in the predicted direction with share prices or the non-market-based estimate of firm value" (page 200). This finding supports the view that the recognition and measurement (and revaluation), or at least disclosure, of the current value of intangible assets is important from a capital markets perspective.

B3. Matolcsy and Wyatt (2006)[47] found capitalisation of intangible assets encouraged higher analyst following and lower absolute earnings forecast errors for firms with a stock of underlying intangible assets. Barth *et al* (2001)[48] also examined the relationship between analyst coverage and firms' intangible assets. They concluded that:

> Taken as a whole, our evidence points to an important potential implication of non-recognition of intangible assets. In particular, intangible assets, most of which are not recognized as assets in firms' financial statements, are associated with greater incentives for analysts to cover such firms, and greater costs of coverage. An unanswered question is whether financial statement recognition of intangible assets could more efficiently provide information about such assets to investors. (page 30).

Although the Barth *et al* findings do not throw light on the recognition versus disclosure-only approach, the findings strongly suggest that, if

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46 Barth, M.E. and Clinch, G. (1999). 'Revalued financial, tangible, and intangible assets: associations with share prices and non-market-based value estimates', *Journal of Accounting Research*, Volume 36, pp. 199-233.

47 Matolcsy, Z. and Wyatt, A. (2006). 'Capitalized intangibles and financial analysts', *Accounting & Finance*, Volume 46, pp. 457-479.

48 Barth, M.E., Kasznik, R., and McNichols, M.F. (2001). 'Analyst Coverage and Intangible Assets' *Journal of Accounting Research*, Volume 39, pp. 1-34.

financial reports were to provide greater information about intangible assets, costs of coverage are likely to reduce.

B4. Amir *et al* (2003)[49] investigated whether the information available to investors from sources other than financial reports make up for the reports' deficiencies in general, and in intangibles-intensive companies in particular. The authors conclude that:

> Our findings are somewhat mixed – they indicate that analysts' incremental contribution to investors' decisions is larger in R&D-intensive companies than in companies with low levels of (or no) R&D, indicating that the intangibles-related financial report deficiencies are compensated to some extent by other information sources, through analysts' activities. However, this compensation is modest and far from complete, as indicated by the documented association between R&D intensity and the quality (bias and accuracy) of analysts' forecasts. … our evidence suggests the need for a continued concern and action of accounting policymakers with intangibles-related information deficiencies. Sadly, as of this writing, such action has been negligible. (page 657)

B5. Gu and Wang (2005)[50] found a positive association between analysts' forecast errors and the forecast firm's relative intangible intensity. The authors also found that analysts' forecast errors are smaller for biotech and pharmaceutical and medical equipment firms that are subject to intangibles-related regulation.

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49 Amir, E., Lev, B., and Sougiannis, T. (2003). 'Do Financial Analysts Get Intangibles', *European Accounting Review*, Volume 12, pp.635-659.

50 Gu, F. and Wang, W. (2005). 'Intangible assets, information complexity, and analysts' earnings forecasts", *Journal of Business Finance and Accounting*, Volume 32, pp. 1673-1702.

APPENDIX C:
THE APPLICATION OF THE DEFINITION OF AN ASSET TO PLANNED AND UNPLANNED INTERNALLY GENERATED INTANGIBLE ITEMS

INTRODUCTION

C1. In this Appendix we provide an analysis of the two broad types of internally generated intangible items (planned and unplanned) and assess the circumstances under which each satisfies the elements of the current definition of an asset: past event, expected future economic benefits and control.

PLANNED INTERNALLY GENERATED INTANGIBLE ASSETS

C2. Treating planned internally generated intangible items that satisfy the elements of the definition of an asset as assets is consistent with the approach in IFRS 3 *Business Combinations*. For example, paragraph 45 of IFRS 3 anticipates that an in-process research and development project acquired in a business combination may meet the definition of an intangible asset. Similarly, the Illustrative Examples that accompany IFRS 3 (see paragraphs IE16-IE44) anticipate many types of planned intangible assets internally generated by an acquiree that are subsequently acquired by an acquirer in a business combination meeting the definition of an intangible asset.

Past Event

C3. Arguably, the incurrence of attributable costs is a relevant past event for the purpose of contributing towards satisfying the definition of an asset and provides a context for identifying the asset. The incurrence of costs in relation to a planned internally generated intangible asset is arguably even more relevant than a business combination as a context for identifying intangible assets to the extent that a business combination involves the disaggregation of an amount of consideration to its components rather than the allocation of attributable amounts to an aggregate.

Expected Future Economic Benefits

C4. The fact that an entity incurs attributable costs in implementing a discrete plan to create an asset implies that there is an expectation of future economic benefits. This reasoning is consistent with IFRS 3, under which an acquirer's decision to incur costs in excess of the net fair value of its interest in the acquiree's identifiable assets, liabilities and contingent liabilities is regarded as sufficient proof that future

economic benefits associated with the excess (goodwill) are expected to flow to the acquirer.

C5. If future costs are expected to exceed the gross future economic benefits prior to the commencement of a discrete plan, it is reasonable to assume that the plan would not be implemented. It would be expected to be rejected in the feasibility/capital budgeting phase. Presumably it would only be commenced if it were expected to be implemented successfully.

C6. The definition of an asset does not specify that the expected future economic benefits referred to in the definition must equal or exceed the costs incurred. Given the nature of planned internally generated intangible items, it is arguable that, even where the future economic benefits are not expected to equal or exceed the costs, an asset may exist (for example, in the form of knowledge that a research and development project undertaken did not produce a net positive outcome).[51] If a plan to create an intangible asset is found to be 'unsuccessful', which would only be known at the point of abandonment of the plan, the knowledge that the line of enquiry was unsuccessful could satisfy the expected future economic benefits aspect of the definition of an asset. The future economic benefits associated with the knowledge may be that, having incurred the costs, the entity will be able to avoid future costs that would otherwise be incurred to pursue the same line of investigation (paragraph 53 of the *Framework* states: "The future economic benefit embodied in an asset … may … take the form of … a capability to reduce cash outflows …").[52] It is also possible that the entity could sell the knowledge to another entity that wants to avoid incurring costs known to be 'unproductive'. In support of this view, it is relevant to note that paragraph 57 of the *Framework* states:

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51 Work on the definition of assets for the purposes of the IASB/FASB Conceptual Framework project supports this conclusion. Paragraph 19 of a paper *Information for Observers* provided at the 26 April 2006 IASB meeting relating to the project *Conceptual Framework: Elements 4: Asset Definition (III) & Liability Definition (II) (Agenda Paper 8A)* states: "As long as there is a non-zero probability or expectation of economic benefit to the entity at the financial statement date, then the entity has an economic resource."

52 Grossman, G. and Helpman, E. (1994) ("Endogenous Innovation in the Theory of Growth", *Journal of Economic Perspectives*, Volume 8, pp. 23-44) note that: "Knowledge is cumulative, with each idea building on the last... In that sense, every knowledge-orientated dollar makes a productivity contribution on the margin…." (page 31)

> … know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

C7. In contrast to the view expressed in paragraph C6 above, some argue that, in applying the definition of an asset, particularly in a cost-based model, the question to be answered is whether a transaction (incurring costs in implementing a plan) gives rise to future economic benefits. They argue that, because the transaction has two sides (a gross outflow and a related potential gross future inflow of economic benefits), it should be considered from a net perspective – and that only an expected net positive inflow can give rise to an asset (albeit possibly measured at cost).

C8. However, consistent with the view that is emerging in the IASB/FASB Conceptual Framework project, expectation of a gross (positive) inflow is sufficient for an asset to arise/continue to exist. By the nature of planned internally generated intangible items, there is an expectation of future economic benefits irrespective of whether the knowledge was acquired from a 'successful' or 'unsuccessful' project. Under this view, the impact of an expected (negative) net outflow is treated as an impairment/measurement issue rather than as a definition (or recognition) issue.

C9. In concept, a consequence of this view, which is of concern to some, is that amounts representing what would otherwise be losses may give rise to an intangible asset of an entity to the extent they are incurred in implementing a discrete plan (and the knowledge that the plan was not successful is kept secret). However, there would only be limited circumstances where it would be conceptually justifiable to capitalise the losses in practice, because it should only occur to the extent they are attributable to an identifiable asset (eg secret know-how). In any event, they would be subject to recoverability/fair value measurement.

Control

C10. In circumstances where a planned internally generated intangible item will be controlled by the entity (for example, because knowledge acquired from a research and development or other planned project, whether successful or unsuccessful, is expected to be kept secret or otherwise protected) an asset exists.[53] However, in the absence of

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53 Lev (2001) notes on page 83 that a unique characteristic of intangible assets is 'partial excludability' (inability to exclude non-owners from enjoying some benefits), which may lead to a conclusion of lack of control. There is limited guidance on the meaning of control in the *Framework*. However, it is apparent from the examples of intangible assets referred to in the *Framework* (patents, copyrights, know-how kept secret) and in

legal control, an entity might be limited in its capacity to exclude others from capturing some or all of the benefits associated with a project being progressed under a discrete plan intended to create an asset.

C11. Some express concern that treating planned internally generated intangible items as assets could result in spurious costs being capitalised to research the obvious (for example, researching the cancer curing properties of water and then claiming that an asset exists when no cancer curing properties are found). However, such practice is unlikely to be economically rational. Furthermore, arguably, although undertaken through a discrete plan, the outcome is generally known and therefore, in concept, is not controlled because it is not secret know-how. In addition, impairment testing should ensure that inappropriately recognised costs are de-recognised.

UNPLANNED INTERNALLY GENERATED INTANGIBLE ASSETS

Past Event

C12. Paragraph 58 of the *Framework* makes it clear that incurrence of cost, let alone incurrence of attributable costs, is not necessary for an asset to exist:

> The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets; examples include property received by an entity from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits …

Arguably, by analogy with the discovery of mineral deposits, 'discovery' of or identification that or becoming aware that, for example, a brand has been developed out of the day-to-day operations of a business is a relevant past event. However, we acknowledge that discovery of mineral deposits has traditionally been accounted for on a cost attribution basis, which is more akin to planned internally generated intangible assets.

Expected Future Economic Benefits and Control

C13. In the absence of a specific planned project with attributable costs, even if it is accepted that a relevant past event has occurred, there is less of a context for identification and arguably less of a basis for

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IFRS 3 (see paragraph 33 of this Paper) that control is not defined as narrowly as contemplated by Lev.

forming an expectation of future economic benefits and asserting that control exists. Some argue that, although unplanned internally generated intangible assets exist and can be identified conceptually, there is no practical way of identifying them separately from goodwill because there is no event (control point) to justify separate identification, except the advent of reporting date. They express concern that, because the only trigger for identification is a reporting date, this may result in ongoing fair valuation, which would be onerous.

C14. However, to the extent that IFRS 3 acknowledges that an item arising from the day-to-day operations of an acquiree prior to a business combination can meet the definition of an intangible asset in a business combination, the same rationale can apply even in the absence of a business combination. To create a context, as contemplated in paragraphs 52-57 of this Paper, a technique based on a hypothetical business combination could be adopted, whereby the entity is assumed to be an acquiree as at the reporting date, at least for the purpose of initially identifying unplanned internally generated intangible assets.

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