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IAS® Standard 38 Intangible Assets

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CASE STUDY - IAS 38 INTANGIBLE ASSETS

Introduction

Intangible items represent a significant portion of entities' investments, and they are crucial to their functioning and development. However, not all intangible items may be recognized as assets. It is therefore important to understand how investments in intangible items impact the financial statements of an entity.

The aim of this case study is to assess and examine if and when expenditures made for intangible items are recognized as intangible assets in, and to discuss the consequences on, the statement of financial position and on the statement of profit or loss.

The Case Information

You work with the accounting department of Prepare for the future Ltd., an entity operating in the automotive industry, spending impressive budgets on innovation and development activities. The entity's strategy is conceived around quality and innovation. Most of the activities carried out in relation to this strategy are organised in the Development Department. The Department is in charge of preparing staff to be innovative and to produce high quality products, to run campaigns to promote and display the innovative spirit of the entity, and to establish projects to develop new products, or new components that improve existing products. When such a project is focused on a specific component or product, it receives a project number, and it starts to be followed separately.

The expenditures of the Development Department for the year 20X1 are the following (all amounts in CU):

Expenditures	Project X3206	Project X3207	General	Total
Materials	500	1,200	800	2,500
Services	300	2,000	8,300	10,600
Salaries	1,200	2,400	4,700	8,300
Others (rent, utilities etc.)	480	680	3,720	4,880
Total	2,480	6,280	17,520	26,280

This Department is managed as a cost centre, and even if management is highly supportive of investments in innovation, the department manager has a yearly budget of CU20,000 for expenses that she must meet. With this expense budget, the general manager intends to stimulate the department to engage in rewarding projects (which are mainly those resulting in assets; amortisation of assets is not allocated to the department).

The Development Department manager asks you to investigate the expenditures of the year 20X1 and to determine the amount recognized as expenses for the year. She provides you with the following details regarding the activity of the Department:

“20X1 was a very good year for the department, and I hope that most of our work results in assets. I am sure that we will meet our budget for the year.

We worked on two projects: Project X3206 is aimed at improving the mechanism of closing the door of the AlfaJ3 car model. The project was started last year and proved to be successful on March 1. Materials and services were consumed in January, and salaries and other expenses were consumed evenly throughout the year.

Project X3207 started on March 1, and it concerns a new prototype for an electric car. The technical feasibility, intention, and ability to finalise the project were certain on August 1. All expenditures were made evenly throughout the year.

A major training course has been organised for employees, to reduce the number of errors in production. Its amount was of CU3,000 and it is included in the services line for General expenditures.

A major campaign to promote the innovative spirit of the entity has been organised; the cost was of CU2,500 and it is included in the services line for General expenditures.

I believe that these two projects will bring significant benefits to the entity.

My salary (included in the salaries line for General expenditures) was CU200/month. I spent about 10% of my time supervising Project X3206 and about 20% supervising Project X3207.”

Discussion Questions

1. What are the recognition criteria for an intangible asset?
2. Determine the value of intangible assets and that of expenses resulting from the expenditures of the Development Department for the year 20x1.

SOLUTION OF CASE STUDY - IAS 38 INTANGIBLE ASSETS

1. An intangible asset is an identifiable, non-monetary asset without physical substance. An asset is recognized when it meets the definition of an asset (a present economic resource controlled by the entity as a result of past events (CFFR.4.3). An economic resource is a right that has the potential to produce economic benefits (CFFR.4.4)). Moreover, IAS 38 outlines three critical features of an intangible asset: identifiability; control (power to obtain benefits from the asset); future economic benefits (such as revenues or reduced future costs).

2. The activity of the Development Department comprises the following activities:

- training activities – the expenditures cannot be recognized as an asset – control over employees and over the future benefits expected from the skilled staff is not ensured.

- marketing activities – the expenditures cannot be recognized as an asset as there is uncertainty regarding the future benefits.

- research and development activities – research (general documentation, analysis of the market, of competitors' products) is included under the General category, and these expenditures are all expensed. Development activities are carried out for specific projects and are identified as such. However, not all development costs are recognized as assets. Feasibility criteria must be met, and the entity must prove both the intention and the ability to finalise the projects. Capitalization (recognition of an asset) starts when these criteria are met.

Criteria for asset recognition are met for Project X3206 on March 1; therefore, capitalization starts on this date.

The value of intangible assets and of expenses resulting from Project X3206 (all amounts in CU):

Expenditures	Total expenditures	Intangible asset	Expenses
Materials	500 – consumed in January		500
Services	300 – consumed in January		300
Salaries	1,200 – consumed evenly	1,200*10/12 = 1,000	1,200 * 2/12 = 200
Others (rent, utilities etc.)	480 - consumed evenly	480 * 10/12 = 400	480*2/12 = 80
Salary of the manager	200*10%*12 = 240 - consumed evenly	240 * 10/12 = 200	240*2/12 = 40
Total		1,600	1,120

Project X3207 starts on March 1, therefore the work done for this project covers 10 months. Feasibility is proved on August 1, 5 months after inception. Therefore, only half of the period consists in activities that contribute to an asset.

The value of the asset and of expenses is resulting from Project X3207 (all amounts in CU):

Expenditures	Total expenditures	Intangible asset	Expenses
Materials	1,200	600	600
Services	2,000	1,000	1,000
Salaries	2,400	1,200	1,200
Others (rent, utilities etc.)	680	340	340
Salary of the manager	200 * 20% * 10 = 400 - consumed evenly	200	200
Total		3,340	3,340

Concluding, the value of the intangible assets recognized for the period, resulting from the two Projects (as development costs) is: CU1,600 + CU3,340 = CU4,940. The total expenditures of the department are CU26,280. Therefore, of this amount CU4,940 is capitalised as an asset and the rest of CU21,340 are expensed. This amount marginally exceeds the yearly expense budget of CU20,000 that is under the manager’s responsibility. Better control in the future should assist the manager in achieving her target.