



# The intangibles

Sarah Ardiles explains everything you need to know about intangible assets and how they are calculated

**I**nvestors rely on financial statements to make decisions about their investments. But are investors really getting the true picture? More than ever, companies are spending huge amounts of money on intangible assets, for example research and development (R&D).

Indeed, last year Apple spent the best part of \$20 billion on R&D! But often these assets are not recognised on companies' balance sheets. Consequently, a large and widening gap has emerged between a company's market capitalisation and the value of the net assets reported on the balance sheet. So, the question investors are asking is whether the way intangibles are accounted for faithfully represents the company's value?

## Definitions

Let's start at the beginning. What is an asset? Intangible assets (IAS 38) defines an asset as a resource that is controlled by an entity as a result of past events and from which future economic benefits are expected.

And what is an intangible asset? An intangible asset is an identifiable non-monetary asset without physical substance.

Identifiable? What does that mean? An asset is identifiable if it is separable (i.e. it can be sold separately, without selling the whole business) or it arises from contractual or other legal rights.

## The real world

To give you an example, think about a pharmaceutical company. The factory in which the medicines are produced is a tangible asset, whereas the chemical formulae of the medicines, the patents, the permission to make the drugs (the manufacturing licence) and the brand are all intangible assets. Which do you

think is more valuable to the pharmaceutical company, the factories or the intangible assets? There is no contest, right? The intangibles of course. And yet it is often the case that many of a company's intangibles are simply not recognised on their balance sheet.

Why not? Good question. Well, just because a company spends money and expects future benefit, it doesn't make it an asset that is recognised in the financial statements. This is because IAS 38 says that in order to recognise an intangible asset, as well as meeting the definition, two recognition criteria must be met:

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

## Purchased intangibles

These recognition criteria are deemed to always be satisfied where the intangible asset has been purchased by a company from an external party at a price. So if the pharma company acquired a licence to manufacture and sell the drugs, the licence would be capitalised at cost. Similarly, the purchase of the patent would be capitalised at cost. Patents and licences are both examples of purchased intangibles and, just like tangible assets, they are recognised at cost.

## Internally generated intangibles

So, what about the pharmaceutical company's brand? Let's assume the brand has been organically grown (not purchased). As such, it cannot be recognised as an asset. IAS 38 specifically prohibits the recognition of internally generated brands because the expenditure on these brands cannot be distinguished from the cost of building the business as a whole.

Similarly, spending on advertising is expensed.

Finally, how should the chemical formulae of the drugs be accounted for? Well, they have resulted from expenditure on R&D. R&D meets the definition of an intangible asset because it is identifiable (it could be sold separately). But does it get recognised? Go back and look at the two recognition criteria. Presumably the company will know how much it has spent on R&D so the reliable measurement requirement is met. And what about reaching the threshold of probable future economic benefit?

Well, firstly IAS 38 states that research is always expensed. The rationale is that it cannot be demonstrated at the research phase that the expenditure will generate probable future economic benefit. Following a successful research phase, the drug is developed and tested and these development costs are capitalised if certain criteria are met (yes, there are additional recognition criteria for development costs!).

There are six criteria in total (look them up!) and include the ability to demonstrate technical feasibility (of developing the drug), the availability of enough cash and other resources to complete the development, and the existence of a market (to sell the drug). If all of these criteria are met the company must capitalise the development costs. Otherwise, the costs are expensed. This is clearly a matter of judgment. Unsurprisingly, different companies take different views! But many companies end up expensing these costs.

There is an interesting observation here. You could have two pharmaceutical companies with identical cashflows whose balance sheets look very different to each other simply because one company acquires its research and development externally – and therefore capitalises this purchased intangible – and the other generates them internally and so the assets remain invisible.

Arguably, the company which develops internally is not showing the complete picture on their balance sheet. So, as they say, mind the gap! **PQ**

• Sarah Ardiles is a freelance lecturer specialising in FR and SBR