

# The Contribution of IAS 38 'Intangible Assets' to the Financial Reporting

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## Abstract

Under the circumstances of international accounting convergence in China, international accounting standards (IAS) are becoming increasingly significant in the field of accounting. This paper will focus on the properties of "intangible assets" in IAS38. Firstly, it will analyse the complementary role of intangible assets to PPE, then the reflection of measurement uncertainty and prudence, and finally argument about enhancing qualitative characteristics.

## Keywords

Intangible assets; IAS; Measurement uncertainty; Prudence; Enhancing qualitative characteristics.

## 1. Introduction

Even if the whole company of Coca Cola were swallowed up by flames, there would still be many investors competing for providing loans as an investment (Chen et al., 2006). Because it's clear that Coca Cola's intangible assets play a role as a "wide moat" put forward by Buffett that cannot be destroyed easily by fire, and hence formed its own competitive advantages. (BURTON, 2012). To be specific, apart from tangible assets such as plant and equipment, Coca Cola also has a trademark worth about \$80 billion, a packaging bottle worth about \$5.5 million and a formula of Coca Cola that no one can say its value (Chen et al., 2006). This is the charm of intangible assets. In essence, intangible assets do not have a clear boundary line like tangible assets. It is a kind of circulation without direct perception. As a result, they have unlimited development space, while their exchange value is difficult to measure (Chen, 1997). In order to make intangible assets more unambiguous in circulation, IFRS has made provisions in defining the scope of intangible assets, eventually having a clear definition and economic value in the financial statements. Next, the essay will analyse the contribution of IAS 38 'Intangible Assets' to the usefulness of financial reporting from three aspects— supplement to PPE, implementation of "prudence" and "measurement uncertainty", and arguments with the enhancing qualitative characteristics.

## 2. Supplement to PPE

Intangible assets have no entity, but they can effectively supplement and interact with Property, Plant and Equipment (PPE) in circulation to produce multiplier effects. Consequently, they are also important parts that equity investors must consider when investing. According to the definition in IAS38 and IAS36, intangible assets refer to identifiable non-monetary assets which are no physical objects, and PPE are the substances that enterprises have ownership or right to use (eIFRS, 2020). It is known that the most basic function of assets is to create economic benefits (IASB, 2010). However, the speed of realizing value of tangible assets in circulation solely is slow. At this time, only when combined with intangible assets such as property rights can assets realize their economic value faster (Chen, 1997). Therefore, although intangible assets lack direct perception, when effectively combined with tangible assets, they will produce

multiplier value. All in all, in the light of Kaplan & Norton (2004), intangible assets are the ultimate source of sustainable value creation.

In addition, before April 2001, there were no laws and regulations on intangible assets, and only PPE were strictly defined in the balance sheet, which resulted in the price per share in the stock exchange being significantly higher than the shareholders' equity per share (eIFRS, 2020) (Foster, Fletcher & Stout, 2003). For instance, Microsoft's equity of shareholders in its financial statements was about \$68 billion in the late 1990s, but its market value was about four times that amount. (Foster, Fletcher & Stout, 2003). It can be seen that the recognition and pricing of tangible assets is far from enough, because an organization's intangible assets are likely to account for more than 75% of its value (Kaplan & Norton, 2004). If equity investors want to make timely and effective judgments, it is essential to provide information of intangible assets in time. As a result, it is very important for equity investors to make good use of intangible assets.

### 3. Reflection of “Measurement Uncertainty” and “Prudence”

As the recognition and valuation of intangible assets are full of measurement uncertainty, IAS38 has taken a prudent attitude towards them. Because intangible assets have no physical form, they cannot identify the existence of assets through on-site identification of physical entities like houses and equipment (eIFRS, 2020). More specifically, the future economic benefits provided are highly uncertain. For example, if a product with a certain trademark is considered to be inferior, its trademark will also cause negative benefits to the enterprise. Moreover, measurement uncertainty of internal intangible assets is specifically mentioned in IAS38, because its value is potential. For example, trained employees have potential value, but not market value. If the internal process is not aimed at customer value proposition or financial improvement, the potential value of this intangible asset of employee capability cannot be converted into identifiable value, which cannot be recognized at this time (IASB, 2010).

According to the definition in the framework, if the level of measurement uncertainty is very high, whether the estimation can faithfully represent this phenomenon may be questionable, thus the information obtained may not be useful (IASB, 2010). Under the circumstances, neutrality is one of the necessary conditions to provide useful information on faithful representation in the fundamental characteristics. In addition, exercise of prudence helps to stay neutral, and in uncertain situations, prudence is the act of caution when making judgments (IASB, 2010). According to the principle of prudence, IAS 38 states that besides meeting the definition, the recognition of intangible assets must simultaneously have the potential to generate benefits in the future and the cost of assets can be measured reliably. In particular, due to the large measurement uncertainty of internal intangible assets, IAS38 carefully specifies the conditions that it can be (IASB, 2010). In detail, some internal intangible assets such as brand and masthead can only be recognized as assets as part of business combination due to prudence. The cost of other internally generated intangible assets is classified into the cost generated in the research phase or development phase (eIFRS, 2020). For example, before a technology developed by a research institute is released into the market, domestic enterprises have imported relatively mature technology from abroad, so the technology of research institute has lost its market. In this case, the investment and transfer used by the institute in this respect has no market demand and cannot generate benefits for the Institute, so it cannot be regarded as the intangible assets of the institute (Deng, 1995). As for valuation, intangible assets are similar to PPE. In order to accurately express the value, the cost should be determined according to cost model or the revaluation model. Subsequently, it is necessary to conduct amortisation or impairment testing. To be Prudent, in the revaluation model, the fair

value of some intangible assets which may undergo significant and fluctuating changes shall be evaluated annually (eIFRS, 2020).

#### 4. Arguments with the Enhancing Qualitative Characteristics

Finally, conforming to enhancing qualitative characteristics will also increase the usefulness of information, but if the information is irrelevant or cannot provide a faithful representation of the content, then the enhancing qualitative characteristics will not make the information useful (IASB, 2010). Consequently, some features of enhancing qualitative characteristics may be reduced or even inconsistent to achieve such purpose. Considering the four enhancing qualitative characteristics, in IAS38, timeliness and understandability are satisfactory, while compatibility and verifiability are inconsistent. First, in terms of timeliness, as emphasized in previous analysis of valuation, in IAS38, it requires amortisation and impairment testing on a regular basis and sets disclosure time criteria in order to prevent the wrong evaluation of cost (eIFRS, 2020). Next, information excluding complex phenomena will make the information in financial reports easier to understand (IASB, 2010). In IAS38, there is no effective way to judge whether items are regarded as intangible assets, so as soon as there is any non-conforming information, it will not be recognised to make the judgment simple and clear. However, there are disadvantages in this method. The rigid rules do not conform to the economic and common sense, so a lot of value will be ignored (Lev, 2003).

Then, too general classification results in a larger controllable range of rules and a lower comparability. There are many kinds of intangible assets, and there are also different ways to create benefits for enterprises. For example, know-how includes not only design know-how, but also know-how in process and product manufacturing. Moreover, the transfer value of the right to use know-how will vary with the term and terms of the contract (Deng, 1995). However, IAS38 is only classified into six categories: Separate acquisition; Acquisition as part of a business combination; Acquisition by way of a government grant; Exchanges of assets; Internally generated goodwill; and Internally generated intangible assets (eIFRS, 2020). There is no strict definition requirement, which gives management considerable flexibility and manipulation opportunities. In line with the framework, allowing other accounting methods for the same economic situation will reduce comparability (IASB, 2010). Profitable companies like Microsoft or Oracle, for example, will not capitalize on software spending and postpone profits to the future, while companies with lower profits tend to capitalize a lot of software development. Therefore, the accounting rules followed by each company are different, thus the comparability of the two companies will be reduced (Lev, 2003). Last, for verifiability, information on intangible assets cannot be presented well due to miscalculation and misstatement at times. Good verifiable information should become faithful, and disclose necessary assumptions (IASB, 2010). However, for example, most companies do not disclose their spending on brand promotion and software technology, and few companies indicate how much they spend on specific types of research and development, such as basic research or application research (Lev, 2003). As a result, there are inconsistencies in the disclosures by enterprises, resulting in major miscalculations and misstatements. Hence, the information content of financial statement items is seriously deteriorated, thus affecting verifiability.

In conclusion, the provisions of IAS38 "intangible assets" have greatly increased the usefulness of financial reporting, although some limitations in some respects. First, intangible assets together with PPE offer more useful information and can promote the value significantly, which makes it impossible for equity investors to ignore them. Then, due to the high measurement uncertainty of the future economic benefits provided by intangible assets, IAS38 takes a very prudent attitude in the recognition and valuation, which specifically refers to internal intangible assets. Finally, arguments of four enhancing qualitative characteristics in IAS38 are

evaluated. Among them, timeliness and understandability are satisfied, while compatibility and verifiability are inconsistent.

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