

## 1. Objective of HKAS 38

The objective of Hong Kong Accounting Standard (HKAS) 38 *Intangible Assets* is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. HKAS 38 requires an entity to recognise an intangible asset if, and only if, specified criteria are met. HKAS 38 also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

***Carrying amount is the amount at which an asset is recognised in the balance sheet after deducting any accumulated amortisation and accumulated impairment losses thereon. (HKAS 38 para. 8)***

## 2. Scope of HKAS 38

*HKAS 38 shall be applied in accounting for intangible assets, except:*

- (a) intangible assets that are within the scope of another Standard;*
- (b) financial assets, as defined in HKAS 39 Financial Instruments: Recognition and Measurement;*
- (c) the recognition and measurement of exploration and evaluation assets (see HKFRS 6 Exploration for and Evaluation of Mineral Resources); and*
- (d) expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources. (HKAS 38 para. 2)<sup>2</sup>*

If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of HKAS 38. For example, HKAS 38 does not apply to (a) intangible assets held for trading (HKAS 2 *Inventories*), (b) leases within the scope of HKAS 17 *Leases*, and (c) goodwill acquired in a business combination (HKFRS 3 *Business Combinations*).

Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film. In determining whether an asset that incorporates both intangible and tangible elements should be treated under HKAS 16 *Property, Plant and Equipment* or as an intangible asset under HKAS 38, an entity uses judgement to assess which element is more significant.

## 3. Definition of Intangible Assets

***An intangible asset is an identifiable non-monetary asset without physical substance. (HKAS 38 para. 8)***

***An asset is a resource:***

- (a) controlled by an entity as a result of past events; and*
- (b) from which future economic benefits are expected to flow to the entity.*

***Monetary assets are money held and assets to be received in fixed or determinable amounts of money. (HKAS 38 para. 8)***

<sup>1</sup> This note is sourced from HKAS 38 *Intangible Assets*. While the summary is aimed at covering all critical points of HKAS 38, a complete and comprehensive coverage should still be the original standard, HKAS 38.

<sup>2</sup> All the paragraphs in the HKAS have equal authority now. While certain paragraphs in HKAS are highlighted in bold and italic, the same format is adopted in this note for those paragraphs.

### 3.1 Intangible Assets

Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, licences and trademarks. Common examples of items encompassed by these broad headings are computer software, fishing licences, import quotas and marketing rights. However, not all the items described above meet the definition of an intangible asset that includes:

- (a) identifiability (see section 3.2 below),
- (b) control over a resource (see section 3.3 below) and
- (c) existence of future economic benefits (see section 3.4 below).

If an item within the scope of HKAS 38 does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date (see section 5 below).

### 3.2 Identifiability

The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill.

*An asset meets the identifiability criterion in the definition of an intangible asset when it:*

- (a) *is separable,*  
*i.e. 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, asset or liability;*  
*or*
- (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. (HKAS 38 para. 12)*

### 3.3 Control

An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. Its capacity to control such future economic benefits would normally stem from legal rights that are enforceable in a court of law. In the absence of such rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.

In normal situation, in the absence of legal rights to protect, an entity usually has insufficient control over the expected future economic benefits arising from, for example, a team of skilled staff, or customer relationships and loyalty in order to meet the definition of an intangible asset.

### 3.4 Future Economic Benefits

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

**Examination question: Fine for illegal receipt of a state subsidy**

**Question**

*Modified from ACCA Paper 3.6H 2004 December Question 4(iv)*

Pohler Speed was fined on 10 October 2004 for the receipt of state subsidies that were contrary to a supra-national trade agreement. The subsidies were used to offset trade losses in previous years.

Pohler Speed has to repay to the government \$300 million plus interest of \$160 million. The total repayment has been treated as an intangible asset which is being amortised over 20 years with a full year's charge in the year. (4 marks)

### Answers

The payment of the fine constitutes a cost to the company and is not an intangible asset. An intangible asset is a resource controlled by the company as a result of past events and from which future economic benefits are expected to flow (HKAS 38). This payment does not meet this definition. The subsidy was used to offset trading losses and, therefore, the fine should be charged against current year's profits and disclosed as a separate line item under HKAS1 'Presentation of Financial Statements'.

## 4. Recognition and Measurement

The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

- (a) the definition of an intangible asset (see section 3 above); and
- (b) the recognition criteria (see section 4.1 below).

This requirement applies to costs incurred initially to acquire or internally generate an intangible asset and those incurred subsequently to add to, replace part of, or service it.

### 4.1 Recognition criteria and initial measurement

*An intangible asset shall be recognised if, and only if:*

- (a) *it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and*
- (b) *the cost of the asset can be measured reliably.* (HKAS 38 para. 21)

*An entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.* (HKAS 38 para. 22)

*An intangible asset shall be measured initially at cost.* (HKAS 38 para. 24)

***Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other HKFRSs, e.g. HKFRS 2 Share-based Payment.*** (HKAS 38 para. 8)

### 4.2 Separate Acquisition

The probability recognition criterion in point (a) in section 4.1 above is always considered to be satisfied for separately acquired intangible assets. The cost of a separately acquired intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

The cost of a separately acquired intangible asset comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and
- (b) any directly attributable cost of preparing the asset for its intended use.

Examples of directly attributable costs are:

- (a) costs of employee benefits arising directly from bringing the asset to its working condition;
- (b) professional fees arising directly from bringing the asset to its working condition; and
- (c) costs of testing whether the asset is functioning properly.

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

- (a) costs of introducing a new product or service (including advertising and promotion costs);

- (b) costs of conducting business in a new location or with a new class of customer, and
- (c) administration and other general overhead costs.

Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an intangible asset are not included in the carrying amount of that asset. For example, the following costs are not included in the carrying amount of an intangible asset:

- (a) costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use; and
- (b) initial operating losses.

### 4.3 Acquisition as Part of a Business Combination

In accordance with HKFRS 3 *Business Combinations*, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. Since the effect of probability is reflected in the fair value measurement of the intangible asset. Therefore, the probability recognition criterion in point (a) of section 4.1 above is always considered to be satisfied for intangible assets acquired in business combinations.

In accordance with HKAS 38 and HKFRS 3, an acquirer recognises at the acquisition date separately from goodwill an intangible asset of the acquiree if the asset's fair value can be measured reliably, irrespective of whether the asset had been recognised by the acquiree before the business combination. This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset and its fair value can be measured reliably.

An acquiree's in-process research and development project meets the definition of an intangible asset when it:

- (a) meets the definition of an asset; and
- (b) is identifiable, i.e. is separable or arises from contractual or other legal rights.

The fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be recognised separately from goodwill. 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, rather than demonstrates an inability to measure fair value reliably.

If an intangible asset acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably.

***Research or development expenditure that:***

- (a) relates to an in-process research or development project acquired separately or in a business combination and recognised as an intangible asset; and***
- (b) is incurred after the acquisition of that project***

***shall be accounted for in accordance with paragraphs 54-62 of HKAS 38*** (see section 4.7.2 and 4.7.3 below). (*HKAS 38 para. 42*)

### 4.4 Acquisition by way of a Government Grant

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. Examples include licences to operate radio stations, or import quotas. In accordance with HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, an entity may choose to recognise both the intangible asset and the grant initially at fair value. If an entity chooses not to recognise the asset initially at fair value, the entity recognises the asset initially at a nominal amount (the other treatment permitted by HKAS 20) plus any expenditure that is directly attributable to preparing the asset for its intended use.

## 4.5 Exchanges of Assets

One or more intangible assets may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence.

The cost of such an intangible asset is measured at fair value unless

- (a) the exchange transaction lacks commercial substance or
- (b) the fair value of neither the asset received nor the asset given up is reliably measurable.

The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

The above requirement is similar to the requirement in HKAS 16 *Property, Plant and Equipment* (see the note of HKAS 16).

## 4.6 Internally Generated Goodwill

*Internally generated goodwill shall not be recognised as an asset.* (HKAS 38 para. 48)

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (i.e. it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

## 4.7 Internally Generated Intangible Assets

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.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an entity applies the requirements and guidance in paragraphs 52-67 of HKAS 38 (see section 4.7.1 to 4.7.4 below) to all internally generated intangible assets.

### 4.7.1 Recognition criteria for internally generated intangible assets

To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

- (a) a research phase (see section 4.7.2 below); and
- (b) a development phase. (see section 4.7.3 below) Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of HKAS 38.

***Research*** is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. (HKAS 38 para. 8)

***Development*** is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use. (HKAS 38 para. 8)

If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

#### 4.7.2 Research Phase

***No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred. (HKAS 38 para. 54)***

In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred. Examples of research activities are:

- (a) activities aimed at obtaining new knowledge;
- (b) the search for, evaluation and final selection of, applications of research findings;
- (c) the search for alternatives for materials, devices, products, systems or services; and
- (d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

#### 4.7.3 Development Phase

***An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:***

- (a) *the technical feasibility of completing the intangible asset so that it will be available for use or sale.*
- (b) *its intention to complete the intangible asset and use or sell it.*
- (c) *its ability to use or sell the intangible asset.*
- (d) *how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.*
- (e) *the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.*
- (f) *its ability to measure reliably the expenditure attributable to the intangible asset during its development. (HKAS 38 para. 57)*

In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase. Examples of development activities are:

- (a) the design, construction and testing of pre-production or prototypes and models;
- (b) the design of tools, moulds and dies involving new technology;
- (c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
- (d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

To demonstrate how an intangible asset will generate probable future economic benefits, an entity assesses the future economic benefits to be received from the asset using the principles in HKAS 36 *Impairment of Assets*. If the asset will generate economic benefits only in combination with other assets, the entity applies the concept of cash-generating units in HKAS 36.

Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources. In some cases, an entity

demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

***Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets. (HKAS 38 para. 63)***

Expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

#### 4.7.4 Cost of an Internally Generated Intangible Asset

The cost of an internally generated intangible asset for the purpose of paragraph 24 of HKAS 38 (see section 4.1 above) is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria in paragraphs 21, 22 and 57 of HKAS 38 (see section 4.1 above and 4.7.3 above). Paragraph 71 of HKAS 38 (see section 5.1 below) prohibits reinstatement of expenditure previously recognised as an expense.

##### **Example**

1. An entity is developing a new production process. During 2005, expenditure incurred was \$1,000, of which (a) \$900 was incurred before 1 December 2005 and (b) \$100 was incurred between 1 December 2005 and 31 December 2005.

The entity is able to demonstrate that, at 1 December 2005, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be \$500.

##### At the end of 2005

The production process is recognised as an intangible asset at a cost of \$100 (expenditure incurred since the date when the recognition criteria were met, i.e. 1 December 2005). The \$900 expenditure incurred before 1 December 2005 is recognised as an expense because the recognition criteria were not met until 1 December 2005. This expenditure does not form part of the cost of the production process recognised in the balance sheet.

2. During 2006, expenditure incurred is \$2,000. At the end of 2006, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be \$1,900.

##### At the end of 2006

The cost of the production process is \$2,100 (\$100 expenditure recognised at the end of 2005 plus \$2,000 expenditure recognised in 2006). The entity recognises an impairment loss of \$200 to adjust the carrying amount of the process before impairment loss (\$2,100) to its recoverable amount (\$1,900). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in HKAS 36 are met.

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are:

- (a) costs of materials and services used in generating the intangible asset;
- (b) costs of employee benefits arising from the generation of the intangible asset;
- (c) fees to register a legal right; and
- (d) amortisation of patents that are used to generate the intangible asset.

HKAS 23 *Borrowing Costs* specifies criteria for the recognition of interest as an element of the cost of an internally generated intangible asset.

The following are not components of the cost of an internally generated intangible asset:

- (a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

- (b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and
- (c) expenditure on training staff to operate the asset.

### Examination question

#### Question

*Modified from HKICPA CPA QP FPE 2004 June Paper I Question 1(e)*

Perfect Industry Company Limited (PI) is an experienced original equipment manufacturer (OEM) in cameras. However, it focuses in film camera production while its production in compact digital cameras (CDC) is only accounted for 10% of its production. PI realises that the market for traditional film cameras is declining in terms of demand and profit margin because customers are shifting to digital cameras.

In view of the market sentiment, PI is considering to become an original brand manufacturer (OBM) for budget CDC, CDC with lower pixels by using its "Perfection" brand. Following this strategy, PI could retain its manufacturing facilities with minimum modification at a cost of approximately HK\$10 million. However, substantial expenditure would be needed to develop the company's brand name "Perfection" in the PRC market over the next few years. In the long run, PI may need to outsource its manufacturing activities and form joint ventures with PRC manufacturers. Following this option, PI would need to reposition itself as a market-oriented organization rather than a manufacturing organization.

Discuss the key financial reporting issues in relation to the development costs of the brand name "Perfection" in the PRC.

#### Answers

If PI implements the strategy, substantial brand name development expenditure will be incurred in the next few financial years. The key financial reporting issue is whether this expenditure should be capitalised as an intangible asset or be expensed as and when it is incurred.

Some expenditure incurred with a view to generate future economic benefits does not result in the recognition of an intangible asset mainly because it is not an identifiable resource controlled by the company. Such expenditure is often described as contributing to internally generated goodwill.

HKAS 38 specifically prohibits the recognition of internally generated goodwill as an asset. In particular, HKAS 38 specifically prohibits the recognition of internally generated brands as intangible assets. (para. 63)

HKAS 38 takes the view that such internally generated brands are not capable of being distinguished from the cost of developing the business of the company as a whole. Internally generated brands are not recognised as intangible assets since they are often indistinguishable from internally generated goodwill.

Therefore, if PI pursues the strategy, the brand name development expenditure to be incurred in the next few years cannot be capitalised as an intangible asset even though such expenditure is incurred with a view to generate future economic benefits.

## 5. Recognition of an Expense

***Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:***

(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see section 4 above);  
or

***(b) the item is acquired in a business combination and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of the business combination) shall form part of the amount attributed to goodwill at the acquisition date (see HKFRS 3 Business Combinations). (HKAS 38 para. 68)***

Other examples of expenditure that is recognised as an expense when it is incurred include:

- (a) expenditure on start-up activities (ie start-up costs), unless this expenditure is included in the cost of an item of property, plant and equipment in accordance with HKAS 16.
- (b) expenditure on training activities.
- (c) expenditure on advertising and promotional activities.
- (d) expenditure on relocating or reorganising part or all of an entity.

## 5.1 Past Expenses not to be Recognised as an Asset

*Expenditure on an intangible item that was initially recognised as an expense shall not be recognised as part of the cost of an intangible asset at a later date. (HKAS 38 para. 71)*

**Examination question:** Data purchase and data capture costs

**Question**

*Modified from ACCA Paper 3.6H 2003 June Question 4(ii)*

The intangible assets of Issue are the data purchase and data capture costs of internally developed databases and are capitalised as development expenditure and written off over 4 years.

**Answers**

HKAS 38 sets out the criteria that should be met in order to recognise an internally generated intangible asset. As regards development costs, the company is required to demonstrate that the intangible asset will generate net cash inflows in excess of the cash outflows (future economic benefit!). Also development costs of an asset, which have been recognised, are subject to an impairment test under HKAS 36 *Impairment of Assets*. The criteria to recognise these costs used by Issue will need to be scrutinised but it appears at first sight that these costs should have been written off.

**Examination question:** Development inventory

**Question**

*Modified from ACCA Paper 3.6H 2002 December Question 1(iii)*

A group operates in the pharmaceutical industry and incurs a significant amount of expenditure on the development of products. These costs were formerly written off to the income statement as incurred but then reinstated when the related products were brought into commercial use. The reinstated costs are shown as 'Development Inventory'. The costs do not meet the criteria in Hong Kong SSAP 29 'Intangible Assets' for classification as intangibles and it is unlikely that the net cash inflows from these products will be in excess of the development costs. In the current year, Reel has included \$20 million of these costs in inventory. Of these costs \$5 million relates to expenditure on a product written off in periods prior to 1 December 1999. Commercial sales of this product had commenced during the current period. The accountant now wishes to ensure that the financial statements comply strictly with Hong Kong SSAPs as regards this matter.

**Answers**

The 'development costs' have been reinstated having already been written off. The development costs do not meet the criteria in HKAS 38 for capitalisation and amortisation and, although the standard does not specifically preclude this practice, the costs cannot be treated as inventory as they have been previously written off as incurred. (ACCA's answers should also refer to para.71 of HKAS 38, i.e. section 5.1)

HKAS 38 is quite strict as regards the costs which can be classified as development costs partly because the standard relates to all intangible assets and such assets have to show that they will generate probable future economic benefits in excess of the costs. All of the costs will be written off.

## 6. Measurement after Recognition

*An entity shall choose either:*

- (a) *the cost model* (see section 6.1 below), *or*
- (b) *the revaluation model* (see section 6.2 below)

*as its accounting policy. If an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets. (HKAS 38 para. 72)*

**An active market is a market in which all the following conditions exist:**

- (a) *the items traded in the market are homogeneous;*
- (b) *willing buyers and sellers can normally be found at any time; and*
- (c) *prices are available to the public. (HKAS 38 para. 8)*

A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. The items within a class of intangible assets are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements representing a mixture of costs and values as at different dates.

## 6.1 Cost Model

*After initial recognition, an intangible asset shall be carried at its cost less any accumulated amortisation and any accumulated impairment losses. (HKAS 38 para. 74)*

## 6.2 Revaluation Model

*After initial recognition, an intangible asset shall be carried at a revalued amount, being its fair value at the date of the revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.*

*For the purpose of revaluations under HKAS 38, fair value shall be determined by reference to an active market. Revaluations shall be made with such regularity that at the balance sheet date the carrying amount of the asset does not differ materially from its fair value. (HKAS 38 para. 75)*

*Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. (HKAS 38 para. 8)*

### 6.2.1 Application of revaluation model

The revaluation model does not allow:

- (a) the revaluation of intangible assets that have not previously been recognised as assets; or
- (b) the initial recognition of intangible assets at amounts other than cost.

The revaluation model is applied after an asset has been initially recognised at cost. However, if only part of the cost of an intangible asset is recognised as an asset because the asset did not meet the criteria for recognition until part of the way through the process (see section 4.7.4 above), the revaluation model may be applied to the whole of that asset. Also, the revaluation model may be applied to an intangible asset that was received by way of a government grant and recognised at a nominal amount (see section 4.4 above).

### 6.2.2 An active market

It is uncommon for an active market with the characteristics described above to exist for an intangible asset, although this may happen. For example, in some jurisdictions, an active market may exist for freely transferable taxi licences, fishing licences or production quotas. However, an active market cannot exist for brands, newspaper mastheads, music and film publishing rights, patents or trademarks, because each such asset is unique.

Also, although intangible assets are bought and sold, contracts are negotiated between individual buyers and sellers, and transactions are relatively infrequent. For these reasons, the price paid for one asset may not provide sufficient evidence of the fair value of another. Moreover, prices are often not available to the public.

### 6.2.3 Frequency of revaluations

The frequency of revaluations depends on the volatility of the fair values of the intangible assets being revalued. If the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary. Some intangible assets may experience significant and volatile movements in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for intangible assets with only insignificant movements in fair value.

### 6.2.4 Revaluation effect on accumulated amortisation

If an intangible asset is revalued, any accumulated amortisation at the date of the revaluation is either:

- (a) restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount; or

- (b) eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset.

### 6.2.5 No active market

*If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset shall be carried at its cost less any accumulated amortisation and impairment losses. (HKAS 38 para. 81)*

*If the fair value of a revalued intangible asset can no longer be determined by reference to an active market, the carrying amount of the asset shall be its revalued amount at the date of the last revaluation by reference to the active market less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. (HKAS 38 para. 82)*

The fact that an active market no longer exists for a revalued intangible asset may indicate that the asset may be impaired and that it needs to be tested in accordance with HKAS 36. If the fair value of the asset can be determined by reference to an active market at a subsequent measurement date, the revaluation model is applied from that date.

### 6.2.6 Recognition of revaluation surplus or deficit

*If an intangible asset's carrying amount is increased as a result of a revaluation, the increase shall be credited directly to equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss. (HKAS 38 para. 85)*

If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be debited directly to equity under the heading of revaluation surplus to the extent of any credit balance in the revaluation surplus in respect of that asset.

The cumulative revaluation surplus included in equity may be transferred directly to retained earnings when the surplus is realised. The whole surplus may be realised on the retirement or disposal of the asset. However, some of the surplus may be realised as the asset is used by the entity; in such a case, the amount of the surplus realised is the difference between amortisation based on the revalued carrying amount of the asset and amortisation that would have been recognised based on the asset's historical cost. The transfer from revaluation surplus to retained earnings is not made through the income statement.

#### **Examination question: Music and screen production rights**

##### **Question**

*Modified from ACCA Paper 3.6H 2002 December Question 4(b)*

Transsystems designs websites and writes bespoke software. It disclosed in its financial statements \$15 million of music and screen production rights which it had acquired via the purchase of another subsidiary. The group policy is to classify this intangible as current assets under inventory. Further, during the current financial period, the group has capitalised its domain names acquisition costs of \$1 million within tangible non-current assets, and revalued the asset to \$3 million. (4 marks)

##### **Answers**

HKAS 38 states that if an intangible asset is acquired in a business combination, the cost of that intangible asset is based on its fair value at the date of acquisition assuming that it can be measured reliably. Intangible assets are shown under non-current assets and they are subject to impairment testing and amortisation. The treatment used by Transsystems avoids this and leaves the production rights to be treated under HKAS 2 Inventories. This means that they will be shown at the lower of historical cost and net realisable value.

HKAS 38 is quite convincing in its argument so that the production rights should be treated as intangible assets, amortised and reviewed for impairment. In order to meet the definition of an Intangible Asset, HKAS 38 requires identifiability, control and the existence of future economic benefits. It would appear that the domain names should be shown as an intangible asset and not as a tangible non-current asset. Further on actual recognition, the intangible asset should be measured at cost. Any subsequent revaluation using the allowed alternative treatment is only possible if there is an active market for the intangible. The definition of an 'active market' is quite stringent to the extent that very few intangibles have such a market. Thus the domain name costs should be shown at cost under intangible assets and amortised/reviewed for impairment.

## 7. Useful Life

***Useful life is:***

- (a) the period over which an asset is expected to be available for use by an entity; or*
  - (b) the number of production or similar units expected to be obtained from the asset by an entity.*
- (HKAS 38 para. 8)*

*An entity shall assess whether the useful life of an intangible asset is*

- (a) finite or*
- (b) indefinite*

*and, if finite, the length of, or number of production or similar units constituting, that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.* (HKAS 38 para. 88)

The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised (see section 8 below), and an intangible asset with an indefinite useful life is not (see section 9 below).

### 7.1 Factors considered in determining the useful life

Many factors are considered in determining the useful life of an intangible asset, including:

- (a) the expected usage of the asset by the entity;
- (b) typical product life cycles for the asset and public information on estimates of its useful;
- (c) technical, technological, commercial or other types of obsolescence;
- (d) the stability of the industry in which the asset operates and market demand of its output;
- (e) expected actions by competitors or potential competitors;
- (f) the level of maintenance expenditure required to maintain the status of the assets;
- (g) the period of control over the asset and legal or similar limits on the use of the asset; and
- (h) whether the useful life of the asset is dependent on the useful life of other assets.

The term 'indefinite' does not mean 'infinite'. The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and the entity's ability and intention to reach such a level. A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance.

Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life is short.

The useful life of an intangible asset may be very long or even indefinite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

### 7.2 Intangible asset that arises from contractual or other legal rights

*The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset.*

*If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost. (HKAS 38 para. 94)*

There may be both economic and legal factors influencing the useful life of an intangible asset.

- (a) Economic factors determine the period over which future economic benefits will be received by the entity.
- (b) Legal factors may restrict the period over which the entity controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:

- (a) there is evidence, possibly based on experience, that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent;
- (b) there is evidence that any conditions necessary to obtain renewal will be satisfied; and
- (c) the cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal.

If the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal, the 'renewal' cost represents, in substance, the cost to acquire a new intangible asset at the renewal date.

## 8. Intangible Assets with Finite Useful Lives

### 8.1 Amortisation Period and Amortisation Method

**Amortisation** is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

**Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value. (HKAS 38 para. 8)

*The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life.*

*Amortisation shall begin when the asset is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.*

*Amortisation shall cease at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 Non-current Assets Held for Sale and Discontinued Operations and the date that the asset is derecognised.*

*The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used.*

*The amortisation charge for each period shall be recognised in profit or loss unless this or another Standard permits or requires it to be included in the carrying amount of another asset. (HKAS 38 para. 97)*

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method.

Amortisation is usually recognised in profit or loss. However, sometimes the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the amortisation charge

constitutes part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see HKAS 2 *Inventories*).

## 8.2 Residual Value

***The residual value of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. (HKAS 38 para. 8)***

***The residual value of an intangible asset with a finite useful life shall be assumed to be zero unless:***

- (a) there is a commitment by a third party to purchase the asset at the end of its useful life; or***
- (b) there is an active market for the asset and:***
  - (i) residual value can be determined by reference to that market; and***
  - (ii) it is probable that such a market will exist at the end of the asset's useful life. (HKAS 38 para. 100)***

The depreciable amount of an asset with a finite useful life is determined after deducting its residual value. A residual value other than zero implies that an entity expects to dispose of the intangible asset before the end of its economic life.

An estimate of an asset's residual value is based on the amount recoverable from disposal using prices prevailing at the date of the estimate for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used.

The residual value is reviewed at least at each financial year-end. A change in the asset's residual value is accounted for as a change in an accounting estimate in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The residual value of an intangible asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's amortisation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

## 8.3 Review of Amortisation Period and Amortisation Method

***The amortisation period and the amortisation method for an intangible asset with a finite useful life shall be reviewed at least at each financial year-end. If the expected useful life of the asset is different from previous estimates, the amortisation period shall be changed accordingly.***

***If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortization method shall be changed to reflect the changed pattern. Such changes shall be accounted for as changes in accounting estimates in accordance with HKAS 8. (HKAS 38 para. 104)***

# 9. Intangible Assets with Indefinite Useful Lives

***An intangible asset with an indefinite useful life shall not be amortised. (HKAS 38 para. 107)***

In accordance with HKAS 36 *Impairment of Assets*, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount

- (a) annually, and
- (b) whenever there is an indication that the intangible asset may be impaired.

## 9.1 Review of Useful Life Assessment

*The useful life of an intangible asset that is not being amortised shall be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite shall be accounted for as a change in an accounting estimate in accordance with HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. (HKAS 38 para. 109)*

In accordance with HKAS 36, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. As a result, the entity tests the asset for impairment by comparing its recoverable amount, determined in accordance with HKAS 36, with its carrying amount, and recognising any excess of the carrying amount over the recoverable amount as an impairment loss.

## 10. Recoverability of the Carrying Amount - Impairment Losses

*An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount. (HKAS 38 para. 8)*

To determine whether an intangible asset is impaired, an entity applies HKAS 36 *Impairment of Assets*. That Standard explains when and how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.

## 11. Retirements and Disposals

*An intangible asset shall be derecognised:*

- (a) on disposal; or*
- (b) when no future economic benefits are expected from its use or disposal. (HKAS 38 para. 112)*

*The gain or loss arising from the derecognition of an intangible asset shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It shall be recognised in profit or loss when the asset is derecognised (unless HKAS 17 Leases requires otherwise on a sale and leaseback). Gains shall not be classified as revenue. (HKAS 38 para. 113)*

The disposal of an intangible asset may occur in a variety of ways (e.g. by sale, by entering into a finance lease, or by donation). In determining the date of disposal of such an asset, an entity applies the criteria in HKAS 18 *Revenue* for recognising revenue from the sale of goods. HKAS 17 applies to disposal by a sale and leaseback.

### 11.1 Replacement for part of an intangible asset

If in accordance with the recognition principle in section 4.1 above, an entity recognises in the carrying amount of an asset the cost of a replacement for part of an intangible asset, then it derecognises the carrying amount of the replaced part.

If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or internally generated.

### 11.2 Consideration receivable on disposal

The consideration receivable on disposal of an intangible asset is recognised initially at its fair value. If payment for the intangible asset is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash

price equivalent is recognised as interest revenue in accordance with HKAS 18 reflecting the effective yield on the receivable.

### 11.3 Amortisation continues even intangible assets no longer used

Amortisation of intangible assets with finite useful life does not cease when the intangible asset is no longer used, unless the asset has been fully depreciated or is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5.

## 12. Disclosure

### 12.1 General

*An entity shall disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:*

- (a) whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;*
- (b) the amortisation methods used for intangible assets with finite useful lives;*
- (c) the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;*
- (d) the line item(s) of the income statement in which any amortisation of intangible assets is included;*
- (e) a reconciliation of the carrying amount at the beginning and end of the period showing:*
  - (i) additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;*
  - (ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with HKFRS 5 and other disposals;*
  - (iii) increases or decreases during the period resulting from revaluations under paragraphs 75, 85 and 86 (see section 6.2) and from impairment losses recognised or reversed directly in equity in accordance with HKAS 36 Impairment of Assets (if any);*
  - (iv) impairment losses recognised in profit or loss during the period in accordance with HKAS 36 (if any);*
  - (v) impairment losses reversed in profit or loss during the period in accordance with HKAS 36 (if any);*
  - (vi) any amortisation recognised during the period;*
  - (vii) net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and*
  - (viii) other changes in the carrying amount during the period. (HKAS 38 para. 118)*

An entity discloses information on impaired intangible assets in accordance with HKAS 36 in addition to the above information required by HKAS 38.

HKAS 8 requires an entity to disclose the nature and amount of a change in an accounting estimate that has a material effect in the current period or is expected to have a material effect in subsequent periods. Such disclosure may arise from changes in:

- (a) the assessment of an intangible asset's useful life;
- (b) the amortisation method; or
- (c) residual values.

*An entity shall also disclose:*

- (a) *for an intangible asset assessed as having an indefinite useful life, the carrying amount of that asset and the reasons supporting the assessment of an indefinite useful life. In giving these reasons, the entity shall describe the factor(s) that played a significant role in determining that the asset has an indefinite useful life.*
- (b) *a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements.*
- (c) *for intangible assets acquired by way of a government grant and initially recognised at fair value (see paragraph 44 of HKAS 38, or section 4.4):*
  - (i) *the fair value initially recognised for these assets;*
  - (ii) *their carrying amount; and*
  - (iii) *whether they are measured after recognition under the cost model or the revaluation model.*
- (d) *the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities.*
- (e) *the amount of contractual commitments for the acquisition of intangible assets. (HKAS 38 para. 122)*

When an entity describes the factor(s) that played a significant role in determining that the useful life of an intangible asset is indefinite, the entity considers the list of factors in paragraph 90 of HKAS 38 (see section 7.1 above).

## 12.2 Intangible Assets Measured after Recognition using the Revaluation Model

*If intangible assets are accounted for at revalued amounts, an entity shall disclose the following:*

- (a) *by class of intangible assets:*
  - (i) *the effective date of the revaluation;*
  - (ii) *the carrying amount of revalued intangible assets; and*
  - (iii) *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 (of HKAS 38, see section 6.1);*
- (b) *the amount of the revaluation surplus that relates to intangible assets at the beginning and end of the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders; and*
- (c) *the methods and significant assumptions applied in estimating the assets' fair values. (HKAS 38 para. 124)*

It may be necessary to aggregate the classes of revalued assets into larger classes for disclosure purposes. However, classes are not aggregated if this would result in the combination of a class of intangible assets that includes amounts measured under both the cost and revaluation models.

## 12.3 Research and Development Expenditure

*An entity shall disclose the aggregate amount of research and development expenditure recognised as an expense during the period. (HKAS 38 para. 126)*

## 12.4 Other Information

An entity is encouraged, but not required, to disclose the following information:

- (a) a description of any fully amortised intangible asset that is still in use; and
- (b) a brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria in HKAS 38 or because they were acquired or generated before the version of SSAP 29 *Intangible Assets* issued in 2001 was effective.