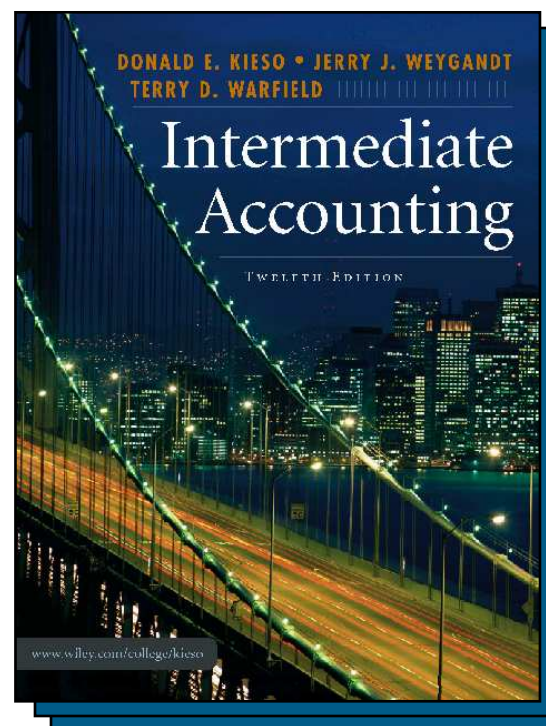


Concepts and Reporting Issues of Intangible Assets

Chapter 12

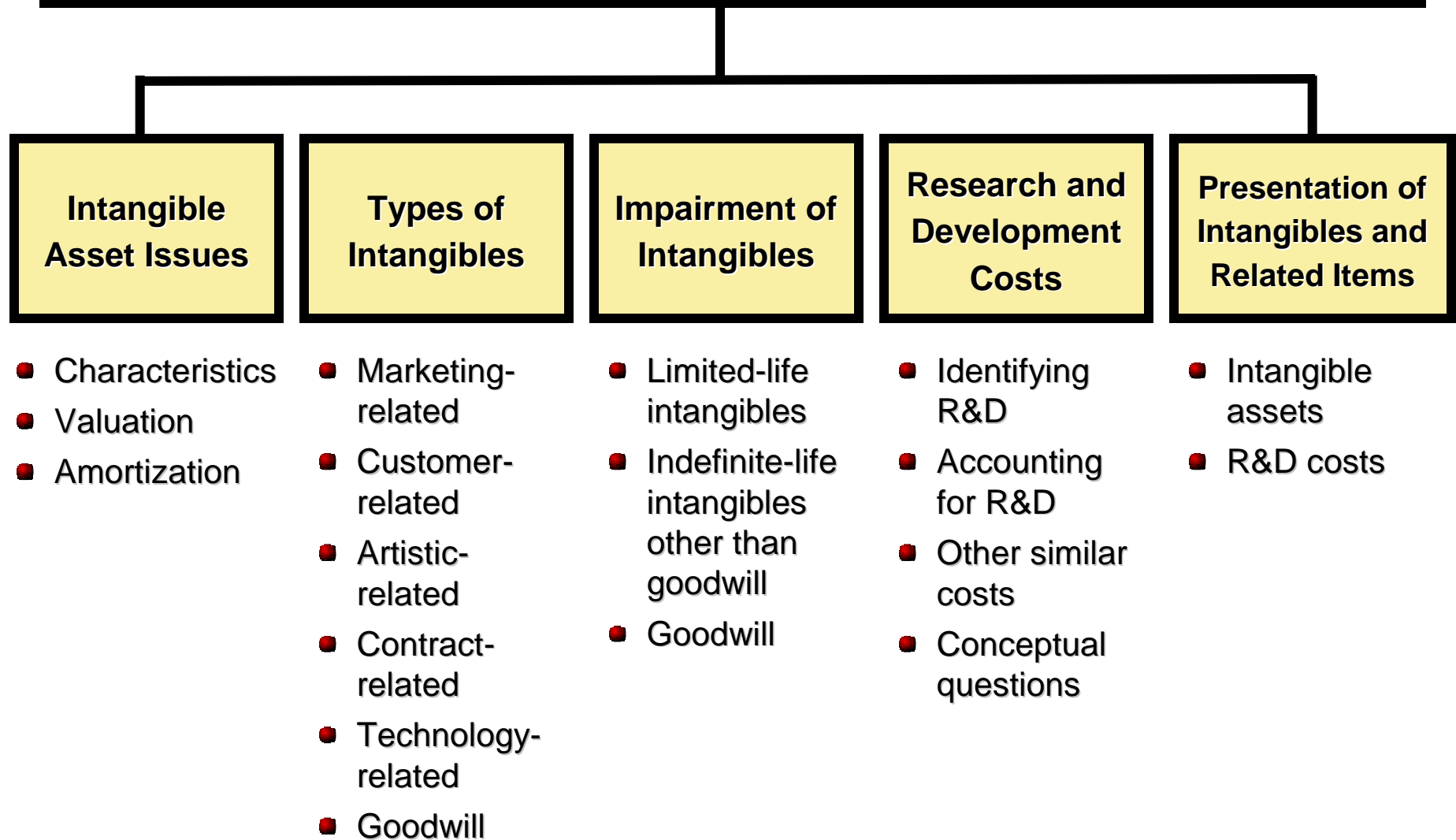
Intermediate Accounting
12th Edition
Kieso, Weygandt, and Warfield



Learning Objectives

1. Describe the characteristics of intangible assets.
2. Identify the costs to include in the initial valuation of intangible assets.
3. Explain the procedure for amortizing intangible assets.
4. Describe the types of intangible assets.
5. Explain the conceptual issues related to goodwill.
6. Describe the accounting procedures for recording goodwill.
7. Explain the accounting issues related to intangible-asset impairments.
8. Identify the conceptual issues related to research and development costs.
9. Describe the accounting for research and development and similar costs.
10. Indicate the presentation of intangible assets and related items.

Intangible Assets



Intangible Asset Issues

Characteristics

Two Main Characteristics:

- (1) They lack physical existence.
- (2) They are not financial instruments.

Normally classified as long-term asset.

Common types of intangibles:

- Patents
- Copyrights
- Franchises or licenses
- Trademarks or trade names
- Goodwill

Intangible Asset Issues

Valuation

Purchased Intangibles:

- Recorded at cost.
- Includes all costs necessary to make the intangible asset ready for its intended use.

Internally Created Intangibles:

- Generally expensed.
- Only capitalize direct costs incurred in developing the intangible, such as legal costs.

Intangible Asset Issues

Amortization of Intangibles

Limited-Life Intangibles:

- Amortize to expense.
- Credit asset account or accumulated amortization.

Indefinite-Life Intangibles:

- No foreseeable limit on time the asset is expected to provide cash flows.
- No amortization.

Intangible Asset Issues

Accounting for Intangibles

Illustration 12-1

Type of Intangible	Manner Acquired		Amortization	Impairment Test
	Purchased	Internally Created		
Limited-life intangibles	Capitalize	Expense*	Over useful life	Recoverability test and then fair value test
Indefinite-life intangibles	Capitalize	Expense*	Do not amortize	Fair value test

*Except for direct costs, such as legal costs.

Types of Intangibles

Six Major Categories:

- (1) Marketing-related.
- (2) Customer-related.
- (3) Artistic-related.
- (4) Contract-related.
- (5) Technology-related.
- (6) Goodwill.

Types of Intangibles

Marketing-Related Intangible Assets

- **Examples** are:
 - trademarks or trade names, newspaper mastheads, Internet domain names, and noncompetition agreements.
- **Trademark** or **trade name** has legal protection for indefinite number of 10 year renewal periods.
- Capitalize acquisition costs.
- No amortization.

Types of Intangibles

Customer-Related Intangible Assets

- **Examples** are:
 - customer lists, order or production backlogs, and both contractual and noncontractual customer relationships.
- Capitalize acquisition costs.
- Amortized to expense over useful life.

Types of Intangibles

Artistic-Related Intangible Assets

- **Examples** are:
 - plays, literary works, musical works, pictures, photographs, and video and audiovisual material.
- **Copyright** is granted for the life of the creator plus 70 years.
- Capitalize acquisition costs.
- Amortized to expense over useful life.

Types of Intangibles

Contract-Related Intangible Assets

- **Examples** are:
 - franchise and licensing agreements, construction permits, broadcast rights, and service or supply contracts.
- **Franchise** (or **license**) with a limited life should be amortized to expense over the life of the franchise.
- Franchise with an indefinite life should be carried at cost and not amortized.

Types of Intangibles

Technology-Related Intangible Assets

- **Examples** are:
 - patented technology and trade secrets granted by the U.S. Patent and Trademark Office.
- **Patent** gives the holder exclusive use for a period of 20 years.
- Capitalize costs of purchasing a patent.
- Expense any R&D costs in developing a patent.
- Legal fees incurred successfully defending a patent are capitalized to Patent account.

Types of Intangibles

Goodwill

Only recorded when an entire business is purchased because goodwill cannot be separated from the business as a whole.

Goodwill is recorded as the excess of ...

*purchase price **over** the FMV of the identifiable net assets acquired.*

Internally created goodwill should not be capitalized.

Recording Goodwill

Example: Global Corporation purchased the net assets of Local Company for \$300,000 on December 31, 2007. The balance sheet of Local Company just prior to acquisition is:

<u>Assets</u>	<u>Cost</u>	<u>FMV</u>	
Cash	\$ 15,000	\$ 15,000	
Receivables	10,000	10,000	
Inventories	50,000	70,000	
Equipment	80,000	130,000	
Total	<u>\$ 155,000</u>	<u>\$ 225,000</u>	} FMV of Net Assets = \$200,000
<u>Liabilities and Equities</u>			
Accounts payable	\$ 25,000	\$ 25,000	
Common stock	100,000		
Retained earnings	30,000		
Total	<u>\$ 155,000</u>	<u>\$ 25,000</u>	

Recording Goodwill

Example: Global Corporation purchased the net assets of Local Company for \$300,000 on December 31, 2007. The balance sheet of Local Company just prior to acquisition is:

Calculation of Goodwill:

Book value of net assets of Local:

Assets	\$ 155,000
Liabilities	(25,000)
Book value of net assets	<u>130,000</u>

Under (Over) valued asset or liabilities:

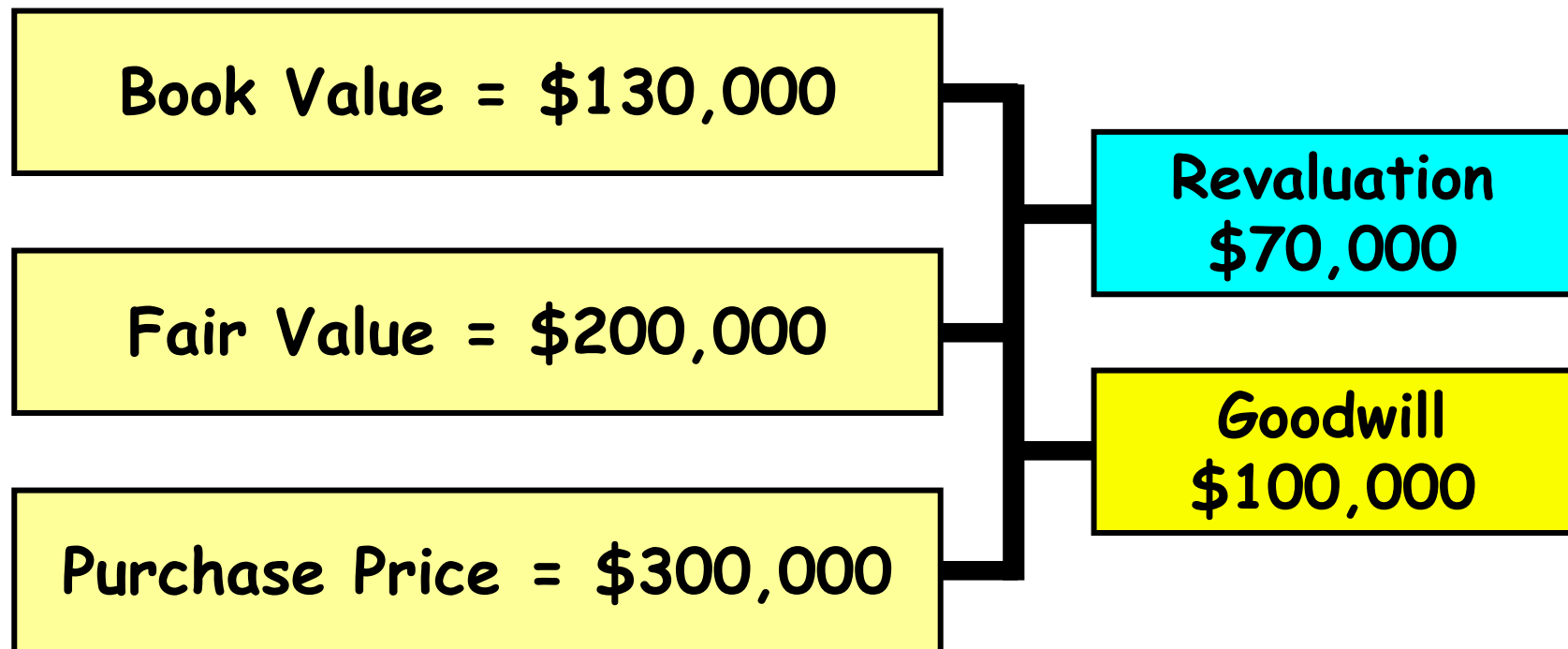
Inventory	20,000
Equipment	50,000
	<u>70,000</u>

FMV of net assets of Local	<u>200,000</u>
----------------------------	----------------

Price paid for Local	<u>300,000</u>
Goodwill	<u>\$ 100,000</u>

Recording Goodwill

Example: Global Corporation purchased the net assets of Local Company for \$300,000 on December 31, 2007. The balance sheet of Local Company just prior to acquisition is:



Recording Goodwill

Example: Global Corporation purchased the net assets of Local Company for \$300,000 on December 31, 2007. The balance sheet of Local Company just prior to acquisition is:

Journal entry recorded by Global:

Cash	15,000	
Receivables	10,000	
Inventory	70,000	
Equipment	130,000	
Goodwill	100,000	
Accounts payable		25,000
Cash		300,000

Goodwill

Goodwill Write-off

- Goodwill considered to have an **indefinite life**.
- Should **not** be amortized.
- Only adjust carrying value when goodwill is impaired.

Goodwill

Negative Goodwill – Bargain Purchase

- Purchase price **less than** the fair value of net assets acquired (bargain purchase).
- Results in a credit, referred to as negative goodwill.
 - Negative goodwill must be allocated against long-term assets acquired, any remaining is accounted for as an extraordinary gain.

Impairment of Intangible Assets

Impairment of Limited-Life Intangibles

Same as impairment for long-lived assets in Chapter 11.

1. If the sum of the expected future net cash flows is **less than** the carrying amount of the asset, an impairment has occurred (**recoverability test**).
2. The impairment loss is the amount by which the carrying amount of the asset exceeds the fair value of the asset (**fair value test**).

The loss is reported as part of income from continuing operations, "Other expenses and losses" section.

Impairment of Intangible Assets

E12-14 (Copyright Impairment) Presented below is information related to copyrights owned by Walter de la Mare Company at December 31, 2007.

Cost	\$ 8,600,000
Carrying amount	4,300,000
Expected future net cash flows	4,000,000
Fair value	3,200,000

The copyright has a remaining useful life of 10 years.

- (a) Prepare the journal entry (if any) to record the impairment of the asset at December 31, 2007.
- (b) Prepare the journal entry to record amortization expense for 2008 related to the copyrights.

Impairment of Intangible Assets

Recoverability test: If the sum of the expected future net cash flows is **less than** the carrying amount of the asset, an impairment has occurred.

Expected future cash flow	\$	4,000,000
Carrying value		4,300,000
		<hr/>
	\$	(300,000)
		<hr/> <hr/>

Asset is Impaired

Impairment of Intangible Assets

- (a) Prepare the journal entry (if any) to record the impairment of the asset at December 31, 2007.

Loss on impairment	1,100,000	
Copyrights		1,100,000

Fair value test:

Carrying amount	\$	4,300,000
Fair value		3,200,000
Loss on impairment	\$	<u>(1,100,000)</u>

Impairment of Intangible Assets

- (b) Prepare the journal entry to record amortization expense for 2008 related to the copyrights.

Amortization expense	320,000	
Copyrights		320,000

Carrying amount	\$	3,200,000
Useful life		÷ 10 years
Amortization per year	\$	<u>320,000</u>

Impairment of Intangible Assets

Impairment of Indefinite-Life Intangibles Other than Goodwill

- Should be tested for impairment at least annually.
- Impairment test is a **fair value test**.
 - If the fair value of asset is **less than** the carrying amount, an impairment loss is recognized for the difference.
 - Recoverability test is not used.

Impairment of Intangible Assets

Impairment of Goodwill

Two Step Process:

Step 1: If fair value is **less than** the carrying amount of the net assets (including goodwill), then perform a second step to determine possible impairment.

Step 2: Determine the fair value of the goodwill (implied value of goodwill) and compare to carrying amount.

Impairment of Intangible Assets

E12-15 (Goodwill Impairment) Presented below is net asset information related to the Carlos Division of Santana, Inc. as of December 31, 2007 (in millions):

Cash	\$	50
Receivables		200
Property, plant, and equipment, net		2,600
Goodwill		200
Less: Notes payable		(2,700)
Net assets	\$	<u>350</u>

Management estimated its future net cash flows from the division to be \$400 million. Management has also received an offer to purchase the division for \$335 million. All identifiable assets' and liabilities' book and fair value amounts are the same.

Impairment of Intangible Assets

E12-15 Instructions

- (a) Prepare the journal entry (if any) to record the impairment at December 31, 2007.

Step 1: The fair value of the reporting unit is below its carrying value. Therefore, an impairment has occurred.

Step 2:	(in millions)
Fair value	\$ 335
Carrying amount, net of goodwill	150
Implied goodwill	185
Carrying value of goodwill	200
Loss on impairment	\$ (15)

Loss on impairment	15,000,000
Goodwill	15,000,000

Impairment of Intangible Assets

E12-15 Instructions

(b) At December 31, 2008, it is estimated that the division's fair value increased to \$345 million. Prepare the journal entry (if any) to record this increase in fair value.

- No entry necessary.
- Adjusted carrying amount of the goodwill is its new accounting basis.
- Subsequent reversal of recognized impairment losses is not permitted under SFAS No. 142.

Impairment of Intangible Assets

Summary of Impairment Tests

Illustration 12-11

Type of Intangible Asset	Impairment Test
Limited life	Recoverability test, then fair value test
Indefinite life other than goodwill	Fair value test
Goodwill	Fair value test on reporting unit, then fair value test on implied goodwill

Research and Development Costs

Frequently results in something that a company patents or copyrights such as:

- new product,
- process,
- idea,
- formula,
- composition, or
- literary work.

Because of difficulties related to identifying costs with particular activities and determining the future benefits, all R & D costs are **expensed when incurred**.

Research and Development Costs

Identifying R & D Activities

Illustration 12-13

Research Activities	Examples
Planned search or critical investigation aimed at discovery of new knowledge.	Laboratory research aimed at discovery of new knowledge; searching for applications of new research findings.
Development Activities	Examples
Translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use.	Conceptual formulation and design of possible product or process alternatives; construction of prototypes and operation of pilot plants.

Research and Development Costs

Accounting for R & D Activities

Costs Associated with R&D Activities:

- Materials, Equipment, and Facilities
- Personnel
- Purchased Intangibles
- Contract Services
- Indirect Costs

Research and Development Costs

E12-1 Indicate how items on the list below would generally be reported in the financial statements.

Item	Classification
1. Investment in a subsidiary company	1. Long-term investments
2. Timberland	2. PP&E
3. Cost of engineering activity required to advance the design of a product to the manufacturing stage.	3. R & D expense
4. Lease prepayment	4. Prepaid rent
5. Cost of equipment obtained under a capital lease.	5. PP&E
6. Cost of searching for applications of new research findings.	6. R & D expense

Research and Development Costs

E12-1 Indicate how items on the list below would generally be reported in the financial statements.

Item	Classification
7. Cost incurred in the formation of a corporation.	7. Expense
8. Operating losses incurred in the start-up of a business.	8. Operating loss
9. Training costs incurred in start-up of new operation.	9. Expense
10. Purchase cost of a franchise.	10. Intangible
11. Goodwill generated internally.	11. Not recorded
12. Cost of testing in search of product alternatives.	12. R & D expense

Research and Development Costs

E12-1 Indicate how items on the list below would generally be reported in the financial statements.

Item	Classification
13. Goodwill acquired in the purchase of a business.	13. Intangible
14. Cost of developing a patent.	14. R & D Expense
15. Cost of purchasing a patent from an inventor.	15. Intangible
16. Legal costs incurred in securing a patent.	16. Intangible
17. Unrecovered costs of a successful legal suit to protect the patent.	17. Intangible

Research and Development Costs

E12-1 Indicate how items on the list below would generally be reported in the financial statements.

Item	Classification
18. Cost of conceptual formulation of possible product alternatives.	18. R & D Expense
19. Cost of purchasing a copyright.	19. Intangible
20. Research and development costs.	20. R & D Expense
21. Cost of developing a trademark.	21. Expensed
22. Cost of purchasing a trademark.	22. Intangible

Research and Development Costs

Other Costs Similar to R & D Costs

- Start-up costs for a new operation.
- Initial operating losses.
- Advertising costs.
- Computer software costs.

Research and Development Costs

E12-17 Compute the amount to be reported as research and development expense.

$$\$280,000 / 5 = \$56,000$$

R&D
Expense

Cost of equipment acquired that will have alternative uses in future R&D projects over the next 5 years.	\$280,000	\$56,000
Materials consumed in R&D projects	59,000	59,000
Consulting fees paid to outsiders for R&D projects	100,000	100,000
Personnel costs of persons involved in R&D projects	128,000	128,000
Indirect costs reasonably allocable to R&D projects	50,000	50,000
Materials purchased for future R&D projects	34,000	0
		<u>\$393,000</u>

Presentations of Intangibles

Balance sheet

- Intangible assets shown as a separate item.
- Contra accounts normally not shown.

Income statement

- Report amortization expense and impairment losses in continuing operations.
- Total R&D costs charged to expense must be disclosed.

Copyright

Copyright © 2006 John Wiley & Sons, Inc. All rights reserved. Reproduction or translation of this work beyond that permitted in Section 117 of the 1976 United States Copyright Act without the express written permission of the copyright owner is unlawful. Request for further information should be addressed to the Permissions Department, John Wiley & Sons, Inc. The purchaser may make back-up copies for his/her own use only and not for distribution or resale. The Publisher assumes no responsibility for errors, omissions, or damages, caused by the use of these programs or from the use of the information contained herein.