INDAS – 38
INTANGIBLE ASSETS

(TOTAL NO. OF QUESTIONS – 8)

INDEX

RTPs QUESTIONS

Q1 (RTP Nov. 18)

In the year to March, 2018, ABC Ltd. spent considerable amounts on designing a new product. ABC Ltd. spent the six months from April, 2017 to September, 2017 researching the feasibility of the product. Mr. X charged these research costs to profit or loss. From October, 2017, .ABC Ltd was confident that the product would be commercially successful and A Ltd. is fully committed to finance its future development. ABC Ltd. spent the remaining part of the year in developing the product, which is expected to start selling in the next few months. These development costs have been recognised as intangible assets in the Balance Sheet. State whether the treatment done by Mr. X is correct when all these research and development costs are design costs Justify your answer with reference to relevant Ind AS.

SOLUTION

As per Ind AS 38 'Intangible Assets', the treatment of expenditure on intangible items depends on how it arose. Internal expenditure on intangible items incurred during the research phase cannot be recognised as an asset. Once it can be demonstrated that a development project is likely to be technically feasible, commercially viable, overall profitable and can be adequately resourced, then future expenditure on the project can be recognised as an intangible asset.

The difference in the treatment of expenditure up to 30th September, 2017 and expenditure after that date is due to the recognition phase i.e. research or development phase. Since ABC Ltd is confident that the product will be commercially successful and is fully committed to finance its future development, the conditions at development stage seem to have met and hence the treatment is justified.

Q2 (RTP Nov. 18 + MTP Oct 19)

A Ltd. intends to open a new retail store in a new location in the next few weeks. It has spent a substantial sum on a series of television advertisements to promote this new store. It has paid for advertisements costing Rs. 8,00,000 before 31st March, 2018. Rs. 7,00,000 of this sum relates to advertisements shown before 31st March, 2018 and Rs. 1,00,000 to advertisements shown in April, 2018. Since 31st March, 2018, A Ltd. has *paid for further advertisements costing Rs. 4,00,000. The accountant charged all these costs as expenses in the year to 31 March 2018. However, CFO of A Ltd. does not want to charge Rs. 12,00,000 against 2017-2018 profits. He believes that these costs can be carried forward as intangible assets because the company's market research indicates that this new store is likely to be highly successful.*

Examine and justify the treatment of these costs of Rs. 12,00,000 in the financial statements for the year ended 31st March, 2018 as per Ind AS.

SOLUTION

- Ind AS 38 specifically prohibits recognising advertising expenditure as an intangible asset. Irrespective of success probability in future, such expenses have to be recognized in profit or loss. Therefore, the treatment given by the accountant is correct since such costs should be recognised as expenses.
- However, the costs should be recognised on an accrual basis.

  Therefore, of the advertisements paid for before 31st March, 2018, Rs. 7,00,000 would be recognised as an expense and Rs. 1,00,000 as a prepayment in the year ended 31st March 2018.

  Rs. 4,00,000 cost of advertisements paid for since 31st March, 2018 would be charged as expenses in the year ended 31st March, 2019.

Q3 (RTP Nov. 18)

One of the senior engineers at XYZ has been working on a process to improve manufacturing efficiency and, consequently, reduce manufacturing costs. This is a major project and has the full support of XYZ's board of directors. The senior engineer believes that the cost reductions will exceed the project costs within twenty-four months of their implementation. Regulatory testing and health and safety approval was obtained on 1 June 20X5. This removed uncertainties concerning the project, which was finally completed on 20 April 20X6. Costs of Rs 18,00,000, incurred during the year till 31st March 20X6, have been recognized as an intangible asset. An offer of Rs 7,80,000 for the newly developed technology has been received by potential buyers but it has been rejected by XYZ. The Senior engineer believes that the project will be a major success and has the potential to save the company Rs 12,00,000 in perpetuity. Director of research at XYZ, Neha, who is a qualified electronic engineer, is seriously concerned about the long-term prospects of the new process and she is of the opinion that competitors would have developed new technology at some time which would require replacing the new process within four years. She estimates that the present value of future cost savings will be Rs 9,60,000 over this period. After that, she thinks that there is no certainty about its future. What would be the appropriate accounting treatment of the aforesaid issue?

SOLUTION

Ind AS 38 'Intangible Assets' requires an intangible asset to be recognised if, and only if, certain criteria are met. Regulatory approval on 1 June 20X5 was the last criterion to be met, the other criteria have been met as follows:

- Intention to complete the asset is apparent as it is a major project with full support from board
- Finance is available as resources are focused on project
- Costs can be reliably measured
- Benefits are expected to exceed costs – (in 2 years)

Amount of Rs 15,00,000 (Rs 18,00,000 x 10/12) should be capitalised in the Balance sheet of year ending 20X5-20X6 representing expenditure since 1 June 20X5.

The expenditure incurred prior to 1 June 20X5 which is Rs 3,00,000 (2/12 x Rs 18,00,000) should be recognised as an expense, retrospective recognition of expense as an asset is not allowed.

Ind AS 36 'Impairment of assets' requires an intangible asset not yet available for use to be tested for impairment annually.

Cash flow of Rs 12,00,000 in perpetuity would clearly have a present value in excess of Rs 12,00,000 and hence there would be no impairment. However, the research director is technically qualified, so impairment tests should be based on her estimate of a four-year remaining life and so present value of the future cost savings of Rs 9,60,000 should be considered in that case.

Rs 9,60,000 is greater than the offer received (fair value less costs to sell) of Rs 7,80,000 and so Rs 9,60,000 should be used as the recoverable amount.

So, the carrying amount should be consequently reduced to Rs 9,60,000.

Calculation of Impairment loss:

Particulars	Amount Rs
Carrying amount (Restated)	15,00,000
Less: Recoverable amount	9,60,000
Impairment loss	5,40,000

Impairment loss of Rs 5,40,000 is to be recognised in the profit and loss for the year 20X5-20X6.

Necessary adjusting entry to correct books of account will be:

Particulars	Rs
Operating expenses- Development expenditure (P/L) Dr.	3,00,000
To Cash / Bank	3,00,000
Impairment Loss (P/L) Dr.	5,40,000
To Intangible assets – Development expenditure	5,40,000

Q4 (Nov. 20)

ABC Pvt. Ltd., recruited a player. As per the terms of the contract, the player is prohibited from playing for any other entity for the coming 5 years and has to be in employment with the company and cannot leave the entity without mutual agreement. The price the entity paid to acquire this right is derived from the skills and fame of the said player. The entity uses and develops the player through participation in matches. State whether the cost incurred to obtain the right regarding the player can be recognised as an intangible asset as per Ind AS 38?

SOLUTION

As per Ind AS 38, for an item to be recognised as an intangible asset, it must meet the definition of an intangible asset, i.e., identifiability, control over a resource and existence of future economic benefits and also recognition criteria.

With regard to establishment of control, Ind AS 38 states that 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. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal 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.

Further, Ind AS 38 provides that an entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

Since the right in the instant case is contractual, identifiability criterion is satisfied. Based on the facts provided in the given case, the player is prohibited from playing in other teams by the terms of the contract which legally binds the player to stay with ABC Ltd for 5 years.

Accordingly, in the given case, the company would be able to demonstrate control. Future economic benefits are expected to arise from use of the player in matches. Further, the cost of obtaining rights is also reliably measurable. Hence, it can recognise the costs incurred to obtain the right regarding the player as an intangible asset. However, careful assessment of relevant facts and circumstances of each case is required to be made.

Q5 (May. 20)

PQR Ltd. is a gaming developer company. Few years back, it developed a new game called 'Cloud9'. This game sold over 10,00,000 copies around the world and was extremely profitable. Due to its popularity, PQR Ltd. released a new game in the 'Cloud9' series every year. The games continue to be the bestseller. Based on Management's expectations, estimates of cash flow projections for the 'cloud9 videogame series' over the next five years have been prepared. Based on these projections, PQR Ltd. believes that cloud9 series brand should be recognised at INR 20,00,000 in its financial statement. PQR Ltd. has also paid INR 10,00,000 to MNC Ltd. to acquire rights of another video game series called the 'Headspace' video game series. The said series have huge demand in the market.

Discuss the accounting treatment of the above in the financial statements of PQR Ltd.

SOLUTION

In order to determine the accounting treatment of 'cloud9 videogame series' and 'Headspace', definition of asset and intangible asset given in Ind AS 38 may be noted:

"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."*

"An intangible asset is an identifiable non-monetary asset without physical substance."

In accordance with the above, for recognising an intangible asset, an entity must be able to demonstrate that the item satisfies the criteria of identifiability, control and existence of future economic benefits.

In order to determine whether 'cloud9 video game series' meet the aforesaid conditions, following provisions of Ind AS 38 regarding Internally Generated Intangible Assets may be noted:

As per Ind AS 38, internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets. Expenditure on such items cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Accordingly, though the cash flow projections suggest that the cloud9 brand will lead to future economic benefits, yet the asset has been internally generated; therefore, the Cloud9 brand cannot be recognised as intangible asset in the financial statements.

In order to determine whether Headspace meets the aforesaid conditions, following provisions of Ind AS 38 regarding 'Separately acquired Intangible Assets' should be analyzed.

As per Ind AS 38, normally, the price an entity pays to acquire separately an intangible asset will reflect expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow. Therefore, the probability recognition criterion in paragraph 21(a) is always considered to be satisfied for separately acquired intangible assets. In addition, 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 Headspace game has been purchased for INR 10,00,000 and it is expected to generate future economic benefits to the entity. Since Headspace game is a separately acquired asset and the future benefits are expected to flow to the entity, therefore, an intangible asset should be recognised in respect of the 'Headspace' asset at its cost of INR 10,00,000. After initial recognition, either cost model or revaluation model can be used to measure headspace intangible assets as per guidance given Ind AS 38. In accordance with this, Headspace intangible asset should be carried at its cost/revalued amount (as the case may be) less any accumulated amortization and any accumulated impairment losses.

Q6 (May. 20)

X Ltd. purchased a franchise from a restaurant chain at a cost of Rs1,00,00,000 under a contract for a period of 10 years. Can the franchise right be recognised as an intangible asset in the books of X Ltd. under Ind AS 38?

SOLUTION

Ind AS 38 'Intangible Assets', defines asset and intangible asset as under:

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.

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

In accordance with the above, for considering an asset as an intangible asset, an entity must be able to demonstrate that the item satisfies the criteria of identifiability, control over a resource and existence of future economic benefits.

In the given case, the franchise right meets the identifiability criterion as it is arising from contract to purchase the franchise right for 10 years. In addition, X Ltd. will have future economic benefits and control over them from the franchise rights. Accordingly, the franchise right meets the definition of intangible asset.

The same can be recognised if the following recognition criteria laid down in para 21 of Ind AS 38 is met:

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.

In the instant case, identifiability criterion is fulfilled, future economic benefits from franchise rights are expected to flow to the entity and cost can also be measured reliably, therefore, X Ltd. should recognise the franchise right as an intangible asset.

QUESTIONS FROM PAST EXAM PAPERS

Q7 (May 19)

CARP Ltd. is engaged in developing computer software. The expenditures incurred by CARP Ltd. in pursuance of its development of software is given below:

(i) Paid Rs. 1,50,000 towards salaries of the program designers.

(ii) Incurred Rs. 3,00,000 towards other costs of completion of program design.

(iii) Incurred Rs.80,000 towards cost of coding and establishing technical feasibility.

(iv) Paid Rs. 3,00,000 for other direct costs after establishment of technical feasibility.

(v) Incurred Rs. 90,000 towards other testing costs.

(vi) A focus group of other software developers was invited to a conference for the introduction of this new software. Cost of the conference aggregated to Rs.60,000.

(vii) On March 15, 2018, the development phase was completed and a cash flow budget was prepared.

Net profit for the year 2017-18 was estimated to be equal Rs. 30,00,000.

How should CARP Ltd. account for the above-mentioned cost as per relevant Ind AS?

SOLUTION

Costs incurred in creating computer software, should be charged to research & development expenses when incurred until technical feasibility/asset recognition criteria have been established for the product. Here, technical feasibility is established after completion of detailed program design.

Particulars	Expensed Out	Capitalized	Reason
Program designers salary	1,50,000		These costs belong to the research phase
Program design cost	3,00,000		
Coding & Technical feasibility	80,000		
Other direct cost		3,00,000	Costs incurred after technical feasibility is established
Other Testing Costs		90,000	
Conference costs	60,000		normal business promotion expense
Total	**5,90,000**	**3,90,000**	

Q8 (Jan 21)

Super Sounds Limited had the following transactions during the Financial Year 2019-2020.

(i) On 1st April 2019, Super Sound Limited purchased the net assets of Music Limited for Rs. 13,2000. The fair value of Music Limited's identifiable net assets was Rs. 10,00,000. Super Sound Limited is of the view that due to the popularity of Music Limited's product, the life of goodwill is 10 years.

(ii) On 4th May 2019, Super Sounds Limited purchased a Franchisee to organize musical shows from Armaan TV for Rs. 80,00,000 and at an annual fee of 2% of musical shows revenue. The Franchisee expires after 5 years. Musical shows revenue was Rs.10,00,000 for financial year 2019-2020. The projected future revenues for financial year 2020-2021 is Rs. 25,00,000 and Rs. 30,00,000 p.a. for the remaining 3 years thereafter.

(iii) On 4th July 2019, Super Sounds Limited was granted a Copyright that had been applied for by Music Limited. During the financial year 2019-2020, Super Sound Limited incurred Rs. 2,50,000 on legal cost to register the Patent and Rs. 7,00,000 additional cost to successfully prosecute a copyright infringement suit against a competitor.

The life of the copyright is for 10 years.

Super Sound Limited follows an accounting policy to amortize all intangible on SLM (Straight Line Method) basis or any appropriate basis over a maximum period permitted by relevant Ind AS, taking a full year amortization in the year of acquisition.

You are required to prepare:

(i) A Schedule showing the intangible section in Super Sound Limited Balance Sheet as on 31st March 2020, and

(ii) A Schedule showing the related expenses that would appear in the Statement of Profit and Loss of Super Sound Limited for the year ended 2019-2020.

SOLUTION

i)

Super Sounds Limited

Balance Sheet (Extract relating to intangible asset) as at 31st March 2020

	Note No.	Rs.
Assets		
(1) Non- current asset		
Intangible assets	1	69,45,000

ii)

Super Sounds Limited

Statement of Profit and Loss (Extract)

for the year ended 31st March 2020

	Note No.	Rs.
Revenue from Operations		10,00,000
Total Revenue		**10,00,000**
Expenses:		
Amortization expenses	2	16,25,000
Other expenses	3	7,20,000
Total Expenses		**23,45,000**

Notes to Accounts (Extract)

1. Intangible Assets

	Gross Block (Cost)			Accumulated amortisation			Net block	
	Opening Balance Rs.	Additions Rs.	Closing balance Rs.	Opening Balance Rs.	Additions Rs.	Closing balance Rs.	Opening Balance Rs.	Closing balance Rs.

Goodwill* (W.N.1)	-	3,20,000	3,20,000	-	-	-	-	3,20,000
Franchise** (W.N.2)	-	80,00,000	80,00,000	-	16,00,000	16,00,000	-	64,00,000
Copyright (W.N.3)		2,50,000	2,50,000		25,000	25,000	-	2,25,000
Total	-	**85,70,000**	**85,70,000**	**-**	**16,25,000**	**16,25,000**	-	**69,45,000**

*As per Ind AS 36, irrespective of whether there is any indication of impairment, an entity shall test goodwill acquired in a business combination for impairment annually. This implies that goodwill is not amortised annually but is subject to annual impairment, if any.

**As per the information in the question, the limiting factor in the contract for the use is time i.e., 5 years and not the fixed total amount of revenue to be generated. Therefore, an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate and amortisation based on time can only be applied.

	Amortization expenses		
	Franchise (W.N.2)	16,00,000	
	Copyright (W.N.3)	25,000	16,25,000
	Other expenses		
	Legal cost on copyright	7,00,000	
	Fee for Franchise (10,00,000 x 2%)	20,000	7,20,000

Working Notes:

	Particulars	
(1)	Goodwill on acquisition of business	
	Cash paid for acquiring the business	13,20,000
	Less: Fair value of net assets acquired	(10,00,000)
	Goodwill	**3,20,000**
(2)	Franchise	80,00,000
	Less: Amortisation (over 5 years)	(16,00,000)
	Balance to be shown in the balance sheet	**64,00,000**
(3)	Copyright	2,50,000
	Less: Amortisation (over 10 years as per SLM)	(25,000)
	Balance to be shown in the balance sheet	**2,25,000**