INTANGIBLE ASSETS – RECOGNITION AND EVALUATION

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Abstract: The specialized literature (IAS 38) defines the intangible asset as an asset that is ”non-monetary, identifiable and without physical substance”. However we cannot state that these assets are not as important as the tangible ones since, in some cases, the commercial fund or a commercial marker considered an intangible asset can be more valuable than some tangible ones. That is why we should not ignore these assets since their highlighting becomes more and more important in the financial reports, as well as their assessment to a right market value reflecting the real asset value, considering the fact that they can generate economic benefits, even though intangible assets may be related to marketing, client or supplier, technology or art.

Keywords: intangible assets, recognition, evaluation, commercial fund, intellectual property

1. Introduction

In time, mostly tangible, mobile assets have been traded on the market, such as real estate, industrial equipment, cars etc., and only a lower rate of the intangible assets, including intellectual property. This proportion tends to become equal since nowadays the emphasis falls on the technology transfer, an intangible asset that does not involve a transfer of tangible assets any more.

The intangible elements are always attached (in the beginning or after the beginning of the action of any human activity from the political, social or economic field), but they have become quite recently the focus of the economic research (only on the micro economy level).[1]

In IAS 38 [2], according to the paragraph 8, the intangible assets are “non-monetary assets, identifiable and without physical substance”, and the paragraph 12 explains the fact that the registered intangible assets must meet the criteria of identifiability.

Intangible assets may be coherently analyzed by means of at least the following dimensions:

- *The legal dimension*: intangible assets are traded on the market, they sometimes generate litigation and require a legal protection at least similar to the one for other types of property.
- *The accounting dimension*: these assets need to be analyzed, recorded, redeemed, re-evaluated; therefore the accounting records require a good knowledge of goodwill and intangible assets distinctively. The accounting work is interested in the registration and recognition of goodwill, in the purchase prices of a business, as well as in the assets included in this business.

- *The financial dimension*: many of the arguments created with respect to the goodwill and other intangible assets are determined, directly or indirectly, by the financial assessments and implications.
- *The intangible asset management dimension* is important if these assets stand for extremely important amounts related to the success of a business. [1]

2. Research methodology

In the current scientific work, I looked for the use of some elements of quality research. Thus, the observation method when gathering information was really useful, especially since the specialized literature is not very rich, whereas legal documents setting provisions of the specialized literature provided the necessary elements for this paper. The methods for data collection, the analysis of the similar content and the data interpretation were other basic elements of the quality research in this paper. [3]

3. Recognition of intangible assets

According to the Order of the Ministry of Public Finances (OMPF) no. 3055/2009 [4] an intangible asset is an identifiable, non-monetary asset, without any material support and possessed for the purpose of using it in the manufacturing process or during the supply of goods or services, in order to be rented to third parties or for administrative purposes.

An intangible asset meets the identifiability criteria when:

a) It is separable or dividable from the entity and sold, transferred, authorized, rented or exchanged, individually or together with a corresponding agreement, an identifiable asset or an identifiable debt; or
b) It results from contractual rights or of any other legal nature, irrespective of the fact that these rights are transferable or separable from the entity or from any other rights and obligations.

An intangible asset is property of an entity as long as this entity can get future economic benefits as a result of that particular asset and it does not allow the access of other entities or it limits their access to the above-mentioned economic benefits. The future economic benefits may derive whether from capitalizing the products or services generated by the asset, from cost savings or from other benefits generated by the entity's use of the asset.

The costs falling on an entity in order to create an intangible asset, as its property until its capitalization on the market, include both the initial capital, and the subsequent operating and maintenance costs.[5]

The intangible assets include the following categories:

- start-up expenditures;
- development expenditures;
- franchising, patents, licenses, trademarks, royalties and similar assets, except for the ones internally generated by the entity;
- commercial fund;
- other commercial assets;
- advance payments to intangible asset suppliers, and
- in-process intangible assets.

Another classification of the intangible assets divides them into marketing assets, client or supplier-related assets, technological or artistic work assets. The intangible assets may be contractual or non-contractual in each of the above-mentioned categories.

Marketing intangible assets are mainly used for product or service marketing or promoting purposes. The examples include trademarks, brands, unique commercial design, internet domain name and non-competition agreements.

The client or supplier-related intangible assets derive from the relationships with or the knowledge about clients or suppliers. Examples can be service or purchase agreements, license or royalty agreements, order registers, labor contracts and relationships with clients.

Technological intangible assets derive from contractual or non-contractual rights to use patented or non-patented technology, databases, formulas, projects, software, processes or networks.

Artistic work intangible assets derive from rights to benefits such as royalties from art works, e.g. playwrights, books, movies and music, as well as non-contractual copyright protection.

The commercial fund represents a special situation. Again according to OMPF no. 3055/2009 [4] "the commercial fund is usually recognized during consolidation and it represents the difference between the acquisition cost and the fair value of the part from the net assets purchased by an entity on the transaction date.

In the individual annual accounting sheets, the commercial fund can be recognized only if there is a transfer of all assets or parts of them, of debts and capitals, irrespective of their resulting from purchasing or merging transactions. The transfer is related to a business, represented by an integrated ensemble of activities and assets that are organized and managed with the purpose of obtaining profits, low costs or other benefits.

The internally-generated commercial fund is not recognized as an asset since it is not an identifiable asset (i.e. it is not separable and it does not derive from contractual legal rights or of other nature) entity-controlled, credibly assessable at cost."

4. Evaluation of intangible assets

The evaluation of intangible assets can be performed both on the date of the balance sheet, together with their inclusion in the financial documents, as well as in order to capitalize them on a regulated market, when there is one.

4.1. Evaluation of intangible assets on the balance sheet date

According to the law, the evaluation of intangible assets in the balance sheet is marked at the incoming value, except for the cumulated adjustments [6].

A few aspects have to be mentioned with respect to the intangible assets and their recording in the accounting documents further to an inventory:

- the inventory of intangible assets shall be carried out by determining their presence and their belonging to the owning entities, and, in the case of patents, licenses, trademarks and other intangible assets, a proof of their presence is necessary based on the land rights or other legal documents certifying certain legal rights; [7]

- in the inventory lists of the in-process intangible assets there shall be mentioned, for each separate item, based on determination of its presence on the spot, name and determined value according to the execution stage and to the workload already performed on the inventory date;[8]

- partially or totally operational investments, without issued registration forms as intangible assets, shall be recorded in distinct inventory lists, whereas the works that stopped being executed, ceased or abandoned, shall be recorded in separate inventory lists, with the reason for their cease or abandonment clearly stated, as well as the approval for cease or abandonment together with the measures suggested for these works. [8]

The correction of the intangible asset value and its adjustment to the inventory level shall be operated, according to the type of existing depreciation, whether by recording an additional amortization if there is an irreversible depreciation noticed, or by creating or supplementing adjustments for depreciation if there is a reversible depreciation noticed.

In order to establish if there are depreciations of intangible assets, other than determination of the fact during inventory, external or internal information sources can be taken into account.

The ***external information sources*** include the following aspects:

- during a certain period of time, the asset's market value decreased significantly more than expected as a consequence of time and usage;
- during a certain period of time, significant changes occurred, with a negative effect on the entity, or this kind of transformations will generate such changes in the near future on the technological, commercial, economic or legal environment where the entity runs its business or on the market the asset is attached to.

The internal information sources can include the following elements:

- there is indication of physical or moral wear-and-tear of the asset;
- during a certain period of time, significant changes occurred, with a negative effect on the entity, or these transformations may generate such changes in the near future, regarding the level and the way the asset is used or expected to be used. Such changes include situations where the asset becomes non-productive, plans for restructuring or cease of the activity the asset is attached to, or plans for surrendering the asset before the previously estimated date;
- the internal reports make available indications of the fact that economic results of an asset are or shall be weaker than expected.

4.2. Evaluation of intangible assets aiming at their capitalization

As in the case of tangible asset, the methods of the three classic approaches are applicable with intangible assets:

(a) the market approach (sales comparison);

(b) the income approach;

(c) the cost approach.

The international evaluation standards admit the fact that: "There are more evaluation approaches, such as the real option approach… Such approaches can be appropriate for evaluating intangible assets in certain situations".[9]

The choice of a certain evaluation method for an intangible asset always depends on circumstances. Most of the times, the use of more evaluation methods is required (two at least) due to the necessity of checking the obtained results.

4.2.1. The market approach – determines the value of an intangible asset by reference to the transactions registered on the market where their transaction price is found, as well as to the sale or purchase offers involving identical or similar assets.

Comparison with previous transactions

Occasionally, an intangible asset can be bought on the market at a price considered the equivalent of its value. The attempt to certify the acquisition price is no aberration. Certifying methods are recommended: e.g. cost savings, generation cost, profit advantage. In its turn, the acquisition price may be useful as a test for the license or franchise values. A number of intangible assets are sold and bought on the market, but the information obtained on this market should aim at each type of intangible asset.[10]

Market transactions

Through this method, the value of an intangible asset is set by reference to the transaction prices or to the “evaluation multiples” involved in the prices of transactions with identical or similar assets.

It stands as a method where an evaluator, based on true information, considers signed transactions under similar circumstances to the specific analyzed case, and he takes into account corrections (positive or negative, based on his own experience) to the circumstances where the transactions standing as point of reference were signed.

In practice, this approach is often used as a testing tool given that intangible assets are unique in most cases. One of the reasons the comparison approach is not usually the main approach consists of the fact that the market where intangible assets are traded can rarely be considered an “active market”.[10]

4.2.2. The income approach – estimates the value of an intangible asset by reference to the updated value of the estimated flows (income, cash, cost saving etc.), which could be obtained by a market participant, owner of the analyzed asset.

The application of the income methods are mostly based on predicted financial information: predicted turnover, estimated operating income, predicted cash flows, duration of estimated useful life etc.

The relief from royalty

This is an applicable method used mostly for the evaluation of patents and licenses. It estimates the value of an intangible asset by comparison with the value of hypothetical royalty payment that would have been saved by taking the asset from a third party.

The owner of intellectual property right may allow others to use this asset in exchange for a royalty amount which is, in most cases, a percentage applied to the sales volume generated by the use of the intellectual property. Normally, such rights stand for 3-7% of the sales, where the highest level reached is 5% from the sales. This percentage varies according to the type of intangible asset, its volume and the risk of the flows generated by the use of the asset.[10]

Additional profits (over-profit method)

This evaluation method of intangible assets applies in the situation where the advantage of possessing and using intangible assets can have a reasonably accurate estimation, an advantage indicated synthetically after all through the net profit. Practically, this method is based on the profits directly provided by the intangible assets.

The presence of a profit or an additional cash flow is due to one of the below:

- a surplus of sales prices (price premium) compared to those competitors who do not possess the analyzed intangible asset;
- a relative cost level that is lower than those competitors' who do not possess the analyzed intangible asset (cost savings);
- a combination of the two sources above.

The additional profit method involves comparing the profit or the predicted cash flow that an economic entity could obtain from using the intangible asset to the one it could obtain from another economic entity that does not use that particular intangible asset.[10]

Exceeding cash flows

This method determines the value of an intangible asset as the updated cash flow value attached to the evaluated intangible asset, after deduction of the cash flows attachable to other assets.

Practically, this method is usually applied for those intangible assets that have a stronger impact on the cash flows. The "contributing" assets are actually only less important assets within the invested capital of the economic entity.[10]

4.2.3. The cost approach – estimates the value of an intangible asset by calculating the cost of its replica, and specifically by determining its replacement cost with an asset capable of providing identical or similar services.

A few types of intangible assets are more frequently used where their replacement costs can be estimated:

- reproduction cost for trained and qualified work force;
- internally generated creation cost for certain software programs;
- creation cost for an internet website.

Creation cost

Even though the creation cost of an intangible asset is quite rarely close to its value, there are situations however where the creation cost method can apply, where the evaluator develops an evaluating technique based on the creation cost of a similar intangible asset. The applicability of this method is limited though and imposed by the lack of certain information able to estimate the consequences of possessing and using such assets. The method is very useful especially as a means of verification and testing the conclusions resulting from applying other methods.[10]

One should keep in mind that, besides the result provided by the application of evaluation methods, adjustments are sometimes necessary, determined by any financial benefit from the amortization of the intangible asset. Such an adjustment is known as "Tax Amortization Benefit" (TAB) and it reflects the savings of the profit tax paid by the entity using that asset as a consequence of the corresponding amortization of the intangible asset.

The formula that calculates the amount of the financial benefit as a result of the amortization deductibility is as follows:

$$TAB = ERNTA\, x \left[\frac{n}{n-(Fcap\, x\, s)} - 1 \right]$$

where:

ERNTA = updated total net relief from royalty;

TAB = tax amortization benefit,

n = number of years for the patent to be amortized;

F_{cap} = capitalizing factor;
s = profit tax rate.[10]

5. Conclusions

Even if at first view these intangible assets do not seem to be of major importance, in time some of them acquired a special significance, and I am referring here to the intellectual property rights. They represented the object of many cases of legal litigation, especially commercial ones, and that is why in other states the law provides harsh punishments for theft of intellectual property. The same situation occurs as far as licenses and patents are concerned. The latter, in the absence of an appropriate market to be traded on, are capitalized by inventors at ridiculous prices, even though they seem to have made the "deal" of a lifetime, and those purchasing them end up amortizing the amounts paid for these patents in a relatively short period of time, sometime between 1 and 3 years in my opinion, whereas the profit reaches its maximum level after this time.

The amounts allocated for keeping these licenses are definitely not minor, but all these expenditures are amortized by cashing certain royalties for them.

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