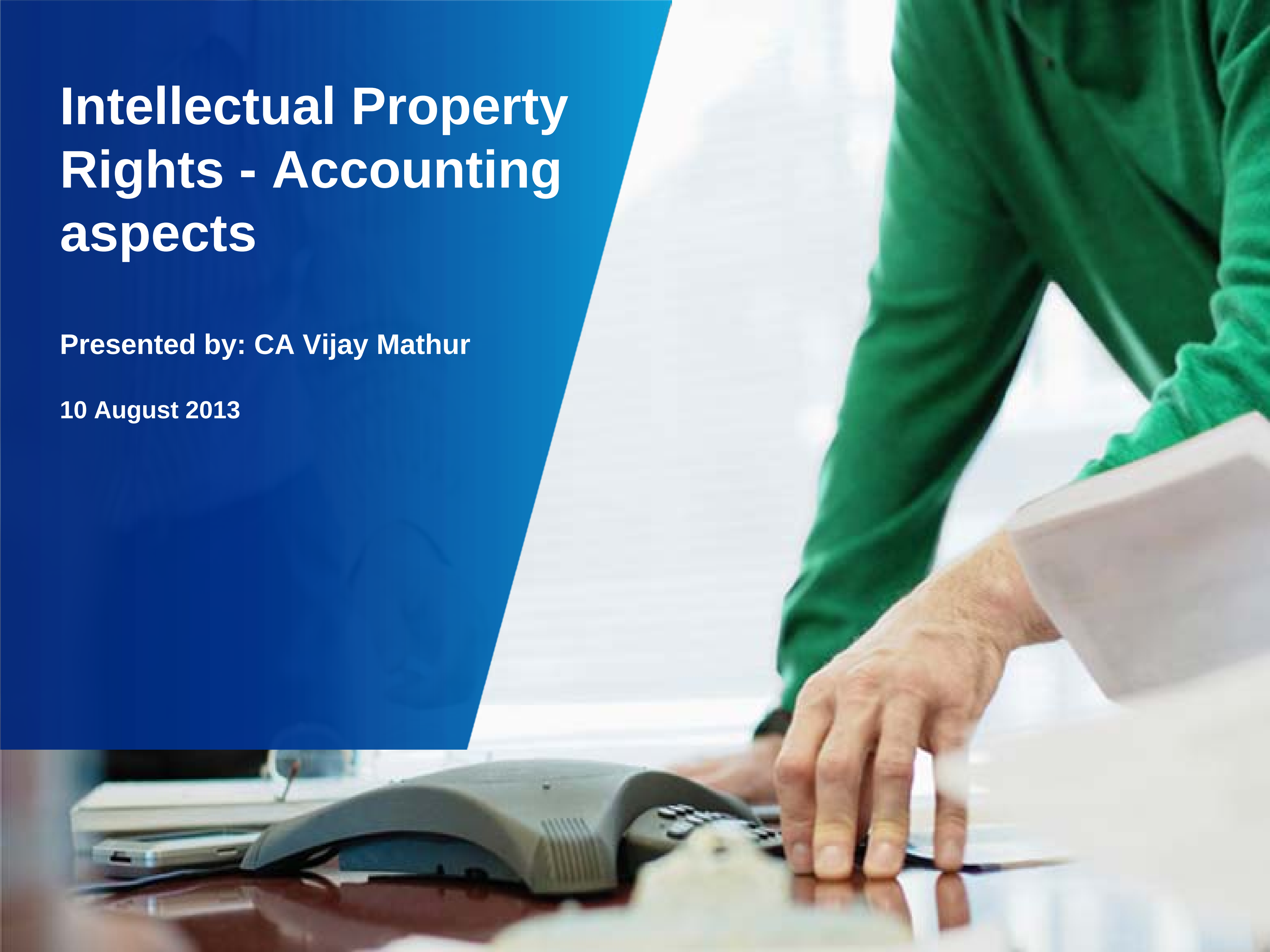
Intellectual Property Rights - Accounting aspects



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Agenda

- Intellectual Property Rights (IPR) - some definitions
- IPR accounting – relevance and challenges
- Accounting aspects – issues and considerations
- Accounting Standards dealing with IPR
- What are Intangible assets?
- Recognition of Intangibles
- Research and Development
- Amortisation and useful life
- Impairment

IPR – Definition

As per World Trade Organisation

Intellectual Property Rights (IPR) are the ***rights given to persons over the creations of their minds***. They usually give the ***creator*** an ***exclusive right*** over the ***use of his/her creation*** for a ***certain period of time***

I Copyright and rights related to copyright

- The rights of authors of literary and artistic works (such as books and other writings, musical compositions, paintings, sculpture, computer programs and films) are protected by **copyright**, for a minimum period of 50 years after the death of the author
- Also protected through copyright and related (sometimes referred to as “neighbouring”) rights are the rights of performers (e.g. actors, singers and musicians), producers of phonograms (sound recordings) and broadcasting organizations. The main social purpose of protection of copyright and related rights is to encourage and reward creative work

II Industrial property

- One area can be characterized as the protection of distinctive signs, in particular **trademarks** (which distinguish the goods or services of one undertaking from those of other undertakings) and geographical indications (which identify a good as originating in a place where a given characteristic of the good is essentially attributable to its geographical origin)
- Other types of industrial property are protected primarily to stimulate innovation, design and the creation of technology. In this category fall inventions (protected by **patents**), **industrial designs** and **trade secrets**

IPR – Definition *(Continued)*

As per Development Commissioner - Micro, Small and Medium Enterprises

Intellectual Property Rights (IPR) are ***legal rights***, which result from intellectual activity in industrial, scientific, literary & artistic fields. These rights ***safeguard creators*** and other producers of intellectual goods & services by ***granting*** them certain ***time-limited rights*** to ***control their use***. Protected IP rights like other property can be a matter of trade, which can be owned, sold or bought

Types of IPR

a. Patents
b. Trademarks/ Brands
c. Copyrights and related rights
d. Geographical Indications
e. Industrial Designs
f. Trade Secrets
g. Layout Design for Integrated Circuits
h. Protection of New Plant Variety

IPR accounting – relevance and challenges

- As corporations around the world are awakening to the revenue-generating potential of intangible assets, the issue of accounting for intellectual property gains importance
- Varying accounting practices are prevalent resulting in differing Balance sheets and Profit and loss accounts
- Due to absence of organised and transparent markets, and subjectivity involved, there are difficulties in determining value of IPRs
- Accounting rules are evolving to enhance reporting/disclosures of IPR
- Gaps exist between the economic framework of accounting, which attempts to record Intangibles as assets, and legal frameworks that record IPR **-** this leads to disparity between what companies show in the balance sheet and what companies actually own
- Is IP Report a need of the hour (in case of internally generated IPs)??

IPR accounting – relevance and challenges *(Continued)*

IPRs **recorded on the balance sheets can be significant ….**

- Pepsi has perpetual brands of USD 4,839 million representing 6% of its total assets
- Walt Disney has copyrights and trademarks aggregating USD 4,273 million representing 6% of its total assets
- Microsoft has technology based and marketing related intangibles of USD 3,083 million representing 2% of its total assets
- Coca Cola has perpetual trademarks of USD 6,527 million representing 8% of its total assets
- Google has patents and developed technology of USD 5,987 million representing 6% of its total assets

Accounting aspects – issues and considerations

- Identifiability – nature?
- Control – ownership /title
- Economic benefits
- At cost / fair value / market value / Revaluation ?
- Valuation techniques --- (subjective)
- Purchased / internally generated
- Capitalise / expense (Research v/s Development)
- Subsequent costs
- Amortisation
- Impairment

Applicability of accounting literature for IPR

- Under Indian GAAP, accounting for IPR is guided by:
  - Accounting Standard 26 ‘Intangible Assets’
  - Accounting Standard 10 ‘Fixed assets’ –
    - As per AS 10, assets are grouped into various categories, such as land, buildings, plant and machinery, vehicles, furniture and fittings, goodwill, patents, trade marks and designs
- Accounting Standard 14 ‘Accounting for Amalgamations’
- Typical industries with IPRs
  - Technology - Microsoft, IBM, Google, Wipro
  - Pharma - Ranbaxy, Pfizer
  - Media and Entertainment – Time Warner, Walt Disney
  - Manufacturing - Pepsi, Coca Cola, Nokia

What is an 'Intangible Asset'

- **As per AS 26 'Intangible asset' is**
  - an identifiable non-monetary asset
  - without physical substance
  - held for use (a) in the production or supply of goods or services, (b) for rental to others, or (c) for administrative purposes
- **An asset is**
  - a resource controlled by an enterprise
  - from which future economic benefits are expected to flow to the enterprise

What is an 'Intangible Asset' *(Continued)*

- AS 26 applies to expenditure on advertising, training, start-up, research and development activities, rights under licensing agreements (for items such as motion picture films, video recordings, plays, manuscripts)
- AS 26 also covers intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights
- Not all the items described above will meet the definition of an intangible asset
- AS 26 does not apply to certain items

Criteria

- **Identifiability**
- **Control**
- **Future economic benefits**

Identifiability

- Clearly distinguished from goodwill – is separable
- Enterprise can rent/sell/exchange/distribute future benefits
- Asset is identifiable even if it generates future benefits in combination with other assets

Control

- Power to obtain future benefits
- Also can restrict access of others to those benefits
- Normally stems from legal rights enforceable in a court of law
- In absence of legal rights, more difficult to demonstrate control

Future economic benefits

- **Revenue**
- **Cost savings**
- **Other benefits from the use of asset**
- **An intangible asset can be recognised if, and only if:**
  - it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
  - the cost of the asset can be measured reliably

Recognition of intangible assets

- *An intangible asset should be measured initially at cost. After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.*
- Per AS 10 (para 15.3) - where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers (eg. Assets/business purchase on ‘Slump’ basis)
- As per AS 26 (para 27), an intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with Accounting Standard 14
- Indian GAAP / US GAAP does not permit Revaluation of Intangibles; under IFRS, intangibles which have an active market (eg. Emission allowance) may be revalued to fair value

Internally generated assets

- Internally generated goodwill not to be recognised as an asset
- Internally generated brands, mastheads, publishing titles, customer lists, etc. not to be recognised as intangible assets
- For other internally generated assets, generation of asset to be classified into (a) Research phase and (b) Development phase
- Costs to exclude Selling, administrative, other general overheads unless they can be directly attributed to making the (intangible) asset ready for use
- *Eg. Software company - Internally generated intangible assets, excluding capitalized development costs, are not capitalized and expenditure is reflected in the statement of profit and loss in the year in which the expenditure is incurred*

Research phase

- **Examples of research phase activities**
  - Activities aimed at obtaining new knowledge
  - Search for, evaluation and final selection of, applications of research findings or other knowledge
  - Search for alternatives for materials, devices, products, processes, systems or services
  - Formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services
- **Research phase costs to be expensed in all cases**

Development phase

Examples of development phase activities:

- Design, construction and testing of pre-production or pre-use prototypes and models
- Design of tools, jigs, moulds and dies involving new technology
- Design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production
- Design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services

Development phase

(Continued)

- **An intangible asset should be recognised if enterprise can demonstrate the following:**
  - Technical feasibility of completing the asset
  - Its intention to complete the asset and use/sell it
  - Its ability to use or sell the intangible asset
  - How the asset will generate probable future economic benefits
  - Availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and
  - Iits ability to measure the expenditure attributable to the intangible asset during its development reliably
- **Cost of internally generated intangible asset comprises expenditure incurred from the time when it first meets the recognition criteria**

Recognition as expense

- **Expenditure on an intangible item to be expensed when incurred unless:**
  - it forms part of the cost of an intangible asset that meets the recognition criteria or
  - the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. In this case, the expenditure (included in the cost of acquisition) should form part of goodwill/capital reserve

Examples of expenditure to be expensed

- **Research**
- **Training activities / team of skilled staff**
- **Advertising/promotional activities (eg. Cost of websites developed for advertising/promotional purposes)**
- **Portfolio of customers, market shares, customer relationships, customer loyalty**
- **Relocation/re-organisation**
- ***Expenditure initially recognised as expense in previous annual/interim financial reports cannot later be recognised as part of cost of an intangible asset***

Subsequent expenditure

- **To be expensed unless -**
  - it is probable that the expenditure will result in future economic benefits in excess of its originally assessed standard of performance and
  - the expenditure can be measured and attributed to the asset reliably
- **Only rarely will subsequent expenditure be added to the cost of the intangible asset (eg. In case of acquired in-process R& D projects)**

Amortisation

- Depreciable amount to be amortised over useful life
- Amortisation should commence when the asset is available for use

Amortisation - method

(Continued)

- **Should reflect the pattern in which the asset's economic benefits are consumed** WDV
- **If that pattern cannot be determined reliably, straight-line method should be used** SLM
- **There will rarely, if ever, be persuasive evidence to support an amortisation method that results in a lower amount of accumulated amortisation than under straight-line method** UOP
- Eg. Extractive industry - *Costs incurred to gain access to mineral reserves are capitalised and amortised over the life of the quarry, which is based on the estimated tonnes of raw materials to be extracted from the reserves*

  Eg. Pharma - Intangible assets comprise patents, trademarks, designs and licenses and computer software which are stated at cost less accumulated amortization (determined on a straight line basis) and impairment losses, if any

Useful life

- **Rebuttable presumption that the useful life of an intangible asset will not exceed ten years. Reasons for taking useful life exceeding ten years to be disclosed highlighting the factors that played a significant role in determining useful life**

- Eg. Consumer goods - *For various brands acquired by the Company, estimated useful life has been determined ranging between 20 to 25 years. The Company believes this based on number of factors including the competitive environment, market share, brand history, product life cycles, operating plan, no restrictions on title and the macroeconomic environment of the countries in which the brands operate. Accordingly, such intangible assets are being amortised over the determined useful life.*

Useful life

(Continued)

- **Computer software and many other intangible assets are susceptible to technological obsolescence and their useful life is thus likely to be short**
  - *Eg.* ***Mfg co.*** *Expenditure on computer software is amortised on straight line method over the period of expected benefit not exceeding five years*
- **If control is achieved through legal rights granted for limited period, useful life not to exceed the period of the legal rights unless:**
  - **the legal rights are renewable and renewal is virtually certain**

  Eg. Mfg co. - *Licenses for Technical know-how have been amortised on a straight line basis over the License term of forty two months*

  Eg. ***Telecom*** *- Bandwidth / Fibre taken on Indefeasible Right of Use (IRU) is amortised over twenty years being the agreement period*
- **Under International GAAP (IFRS/US GAAP), Intangibles can also have indefinite useful life (eg Brands)**

Residual value

- **In determining depreciable amount, residual value should be assumed to be zero unless:**
  - **there is a commitment by a third party to purchase the asset at the end of its useful life or**
  - **there is an active market for the asset and:**
    - residual value can be determined by reference to that market and
    - it is probable that such a market will exist at the end of the asset's useful life

Review of amortisation period / method

- Amortisation period to be reviewed at least at each financial year end and to be changed if expected useful life is significantly different from previous estimates, the amortisation period should be changed accordingly

- Amortisation method to be similarly changed if there has been a significant change in expected pattern of economic benefits

- Both are changes in accounting estimates

Impairment losses

- **Recoverable amount of following assets to be determined at least at each financial year end even if there is no indication of impairment:**
  - intangible assets not yet available for use
  - intangible assets being amortised over a period exceeding ten years from the date when they became available for use
  - Intangible assets with indefinite useful life (under International GAAP)

Derecognition

- **Asset to be derecognised**
  - **on disposal or**
  - **when no future economic benefits are expected from its use and subsequent disposal**

Case study on accounting for software development

Stage	Examples	Accounting treatment
Preliminary stage		
• Strategic decision to allocate resources • Determination of performance requirements • Exploration of alternative performance requirements • Determination of technology • Appointment of consultant for development/ installation of software	• Payroll costs • Administration costs – eg. traveling, rent, communications • External consultants • Purchase of software • Cost of external software services	• Recognised as expense as incurred • Reason – enterprises cannot demonstrate that an asset exists from which future economic benefits are probable

Case study on accounting for software development *(Continued)*

Stage	Examples	Accounting treatment
Development stage		
• Software including program design • Coding of computer software • Beta testing (initial testing) • Testing of function, feature and technical performance of product design	• Same as above – ***Costs not considered for capitalisation*** • Selling, administration and other general overhead expenditure • Clearly defined ineffectiveness and initial operating losses before software achieves planned performance • Staff training costs	• Recognised as assets, if & only if: • Technical feasibility has been achieved • Enterprise has intention to complete software project and use it for intended purpose • Enterprise has ability to use the software • Software will generate future economic benefits • Availability of adequate technical, financial and other resources to complete development and use software • Expenditure can be measured

Case study on accounting for software development *(Continued)*

- **Costs incurred subsequent to development of software shall be capitalised if**
  - probable that future economic benefits are in excess of originally assessed standards of performances
  - expenditure can be reliably measured and attributed to software development
- **Amortisation period**
  - 3 to 5 years or if useful life is a shorter period or software is susceptible to technological obsolescence. Testing for impairment to be carried out annually

Differences between Indian GAAP and IFRS

IFRS	Indian GAAP
Capitalise if recognition criteria are met; intangible assets must be amortised over ***useful life***. Intangibles assigned an indefinite useful life must not be amortised but reviewed annually for impairment. Revaluations are permitted in rare circumstances	Same as IFRS - but there is a rebuttable presumption that the ***useful life*** of intangible assets ***will not exceed 10 years***. Revaluations are not permitted
Provides guidance on recognising customer-related intangibles in absence of legal rights e.g., when there are exchange transactions or when acquired in a business combination	As per the Indian GAAP, in the absence of legal rights to protect or other ways of control, relationships with customers cannot be recognised as intangible assets
Residual value of finite life intangible asset is reviewed at least at each financial year end	The residual value is not revised subsequently

Differences between Indian GAAP and IFRS *(Continued)*

IFRS	Indian GAAP
Intangible assets acquired in a business combination have to be recognised at fair value	If there is no active market for an intangible asset acquired in an amalgamation in the nature of purchase, the cost initially recognised for intangible asset is restricted to an amount that does not create or increase any capital reserve at the date of amalgamation
Post-acquisition R&D expenditure that relates to an in-process R&D project acquired separately or in a business combination shall be accounted as per recognition principles	No guidance is available under the Indian GAAP, though position would be the same as in IFRS

Thank you