

THEME: INTANGIBLE ASSETS

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ACCOUNTING TERM: Intangible Assets

Intangible assets are defined as those non-monetary assets of a company that cannot be seen, touched or physically measured, whereas with a tangible asset you can “stub your toe” on it. Examples of intangible assets include, copyrights, patents, trademarks, trade names, secret formulas, organization costs, franchises, licenses, and goodwill, to name a few.

FEATURE ARTICLE: Identifying Intangible Assets

There is a good chance, even if you are a very small business owner that some day you may have to understand how to record an intangible asset on your books. If that turns out to be the case, then it will be important to know under what rules the intangible asset can be amortized.

First, some background. Intangible assets are divided into two categories:

Identifiable

Identifiable intangible assets are those that can be measured, quantified, and have a separate identity and existence of their own independent of the business as a whole. Patents, copyrights, and that sort of thing are examples of identifiable intangible assets.

For instance, a patent is a grant by the federal government giving the owner the exclusive right to manufacture and sell a particular invention for a period of 17 years. A company may purchase a patent for a specific amount. Same with a copyright which is a grant by the federal government giving an author, creator, or artist the exclusive right to publish, sell, or otherwise control literary or artistic products for the life of the author plus 50 years. A copyright can be purchased for specific amount. In both cases, we know what it is and how much it cost and it could be sold by the business to someone else.

Unidentifiable

Unidentifiable intangible assets are those that cannot exist independent of the business as a whole. Goodwill and organization costs are examples.

Goodwill can only be included as an intangible asset if it is purchased. If goodwill is developed internally it cannot be added. Goodwill usually represents the difference between the fair value of the net assets being sold and the purchase

price. Goodwill, in an acquisition, may or may not actually exist but the buyer is willing to assume it does and pay the asking price. So what we have is an identifiable cost but for an unidentifiable item. You couldn't sell this item to anyone. It is simply an inherent part of the acquisition.

Organization costs are those cost associated with the formal activities required to acquire or set up a business. These are costs such as legal, accounting, registration fees, expenses for meetings, etc. We know what these costs are but we couldn't sell them to anyone outside the business.

This should give you a pretty good idea of what intangible assets are. But how, exactly, are these costs recorded in the books? The costs of intangible assets have to be capitalized. This means they have to be recorded as assets and not expensed. For example:

DESCRIPTION	DEBIT	CREDIT
Intangible Assets	10,000	
Cash (or Payable)		10,000

The next logical question is whether these intangible assets can be amortized (written off) over a period of time? To answer that, we have to dig into the history of accounting since 1970.

Before 1970, it was thought that if an intangible asset had an indefinite life then its cost stayed on the books until the business came to an end. Then in 1970 the Accounting Standards Board (APB) issued Opinion No. 17:

“The Board believes that the value of intangible assets at any one date eventually disappears and that the recorded costs of intangible assets should be amortized by systematic charges to income over the periods estimated to be benefited.”

So they allowed companies to write off some of these intangibles for a period of time, but not longer than 40 years.

Fast forward to 2001, and now we have the APB successor known as the Statement of Financial Accounting Standards (SFAS). They issued Statement 142 essentially saying that allowing intangibles such as goodwill and trademarks to be written off according to some arbitrary useful life was too inaccurate. So they came up with the idea of “impairment”. This means that if you want to write off goodwill, you have to do an annual assessment that measures whether goodwill is impaired. In other words, if goodwill, is diminished in value compared to the amount that is being carried on the balance sheet, then that loss has to be recognized on the books.

The following is an example of a journal entry to amortize an intangible:

DESCRIPTION	DEBIT	CREDIT
Amortization Expense	1,000	
Accum. Amortization		1,000

Accumulated amortization is a contra account that is located under Intangible Assets or under each particular intangible asset in order to show how much of the intangible/s have been written off.

The rub is that trying to figure out whether goodwill is impaired is complicated, vague, subjective, and costly. Many companies don't think it's worth the trouble so leave it alone.

Keep in mind that these rules are for those businesses using a full accrual accounting method and are conforming to Generally Accepted Accounting Principles (GAAP).

QUESTION: Do I Have To Follow SFAS 142 Rules Regarding Intangible Assets?

If you are not using a full accrual method of accounting don't worry about the SFAS 142 rules. If you are using a modified cash basis or strictly cash basis method of accounting then rest easy because there is a much easier approach if you live in the U.S. If you live outside the U.S., you'll have to check what's allowed in your country.

Intangibles still have to be capitalized. But, for amortization purposes use the statutory rates set by the Internal Revenue Service. For most intangible assets that have been purchased (not self-created), a 15 year write off period is allowed. For example, if you purchased \$100,000 of goodwill you would divide that amount by 15. This means your annual amortization expense will be \$6,667. If you bought the intangible during the year divide \$6,667 by 12 and multiply the number of remaining months of the year by \$556 for your first year deduction.

Most small businesses that do not use full accrual accounting use the government's statutory rates to determine not only amortization but depreciation. That way they don't have to maintain a book and tax schedule. Most third party users of the financial statements like banks simply add back the depreciation and amortization expense to the net profit. They know those figures do not accurately represent the operations of the business.

TIP: Some Exceptions To The Rules.

Whether you are using cash or accrual remember that Research and Development costs can be deducted as an expense in the year they are paid or

incurred. Start-up costs and Organization costs are normally amortized over a 15 year period. However, since the American Jobs Creation Act of 2004 an election can be made to write off up to \$5,000 of these costs in the year paid (if cash basis) or incurred (if accrual basis).

Be sure to check with your tax advisor because there are limitations regarding amounts and rules for qualified expenses. But whatever amount you are allowed to deduct on your tax return, use that same amount for your books. Save yourself some time and frustration.

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