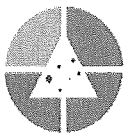
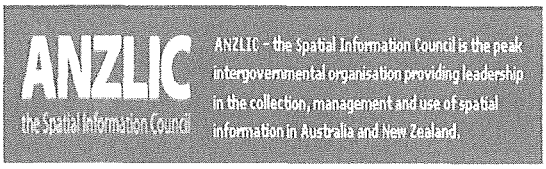




14 May 2009

The Australian Accounting Standards Board
Level 7
600 Bourke Street
Melbourne VIC 3000

By email: standard@aasb.gov.au

Dear Board,

INITIAL ACCOUNTING FOR INTERNALLY GENERATED INTANGIBLE ASSETS – Discussion Paper

Please find attached a joint submission by the Cooperative Research Centre for Spatial Information (CRCSI), by ANZLIC – The Spatial Council, and by the Spatial Industries Business Association (SIBA) on the discussion paper issued by your Office entitled 'Initial Accounting for Internally Generated Intangible Assets'.

We have also attached a paper prepared for us by Corrs, Chambers and Westgarth, and Ernst and Young on the accounting treatment of intangible assets in Australia and especially as they operate to disadvantage the spatial information industry.

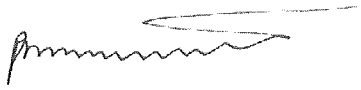
We strongly endorse the need for reform of the Standards and feel the discussion paper makes excellent progress in this regard.

In broad terms, the spatial information sector encompasses both government and private sector entities that collect, develop, manage and use spatial data. Typical examples of spatial data include positioning information from GPSs, Google Earth images, satellite images, aerial images, video, RFID and other sensors, and any information that involves a geographic location or a map. Activities in this sector typically involve using sophisticated information technology systems to manage and exploit data that has a spatial dimension, e.g. cadastral data, information about weather patterns, or data about geographic features or the location of assets in a particular physical area. The sector's activities include developing and implementing data capture technologies for data aggregation, analysis and modelling, and visualisation tools to facilitate use of spatial information.

In 2007 the spatial information industry made a $10 billion contribution to Australia's GDP.

We would be happy to provide additional information.

Yours sincerely,



Dr. Peter Woodgate
CEO – CRC for Spatial Information

Encls.

cc: The NSS Secretariat, at the United Kingdom Accounting Standards Board:
asbcommentletters@frc-asb.org.uk
Mr Warwick Watkins, Chairman - ANZLIC
Ms Liz Marchant, Executive Director - ANZLIC
Mr David Hocking, CEO - SIBA

COMMENTS BY CRCSI, ANZLIC AND SIBA ON THE DISCUSSION PAPER

"INITIAL ACCOUNTING FOR INTERNALLY GENERATED INTANGIBLE ASSETS"

By the Office of the Australian Accounting Standards Board

4 May 2009

COOPERATIVE RESEARCH CENTRE FOR SPATIAL INFORMATION (**CRCSI**)

SPATIAL INDUSTRIES BUSINESS ASSOCIATION (**SIBA**)

ANZLIC – THE SPATIAL INFORMATION COUNCIL (**ANZLIC**)

These comments are provided by CRCSI, SIBA and ANZLIC in response to the above Discussion Paper authored by the Office of the Australian Accounting Standards Board (the **Discussion Paper**).

CRCSI, SIBA and ANZLIC are leading organisations representing the spatial information sector (both government and private enterprise) in Australia. Information on the role of these organisations is available at their websites: http://www.crcsi.com.au, http://www.asiba.com.au and http://www.anzlic.org.au.

Introduction – the spatial information sector in Australia

1 The spatial information sector is an important example, in addition to those mentioned in the Discussion Paper, of a sector of the Australian economy in which intangible assets play a major role.

2 In broad terms, the spatial information sector encompasses both government and private sector entities that collect, develop, manage and use spatial data. Typical examples of spatial data include positioning information from GPSs, Google Earth images, satellite images, aerial images, video, RFID and other sensors, and any information that involves a geographic location or a map. Activities in this sector typically involve using sophisticated information technology systems to manage and exploit data that has a spatial dimension, e.g. cadastral data, information about weather patterns, or data about geographic features or the location of assets in a particular physical area. The sector's activities include developing and implementing:

- data capture technologies;
- systems for data aggregation, analysis and modelling; and
- visualisation tools to facilitate use of spatial information.

3 An independent study by ACIL Tasman indicates that the spatial information industry contributed between $6.4 and $12.6 billion to Australian gross domestic product in 2006-07. Areas of the economy in which spatial information is important include agriculture, forestry and fisheries; mining and resources; property and business services; construction; transport and storage; utilities and communications; retail and trade; tourism; manufacturing; defence, security and emergency services; and government (local, state and federal). Spatial technologies are also fundamental to dealing with global climate change, through meteorological predictions, creation of carbon registries, water management, sea level rise monitoring to name just a few application areas.

This is a world that relies increasingly on 'knowledge-working' and spatial data is central to this world.

4 In the course of their activities, entities in the spatial information sector often internally develop commercially valuable intangible items, e.g. software, databases, brands, patents, customer lists and confidential know-how. (As well, they frequently acquire rights to intangible items from third parties, e.g. rights under a software licence or rights to use and adapt a particular data set.) The sector has for some time been concerned that financial reports complying with current Australian and international accounting standards do not adequately represent the considerable value of intangible items held by entities in the sector.

5 The spatial information industry is one of the fastest growing in the world. It is making an increasingly significant contribution to the worlds economy.

Report on the Accounting Treatment of Intangible Assets in Australia

6 Attached is a Report on the Accounting Treatment of Intangible Assets in Australia, dated 16 October 2008, prepared by Corrs Chambers Westgarth with the assistance of Ernst & Young (the **Report**). This report has been published on CRCSI's website and has been circulated amongst interested participants in the spatial information sector. As can be seen from the report, participants in the sector have taken a strong interest in the requirements of the Australian accounting standards – particularly AASB 138 – regarding the treatment of intangible assets, especially those developed internally.

7 The Report discusses, amongst other things, the application of AASB 138 to the particular types of intangible item that entities in the spatial information sector are most likely to deal with.

8 CRCSI, ASIBA and ANZLIC invite the Australian Accounting Standards Board, the National Standard Setters and the International Accounting Standards Board to consider the whole Report.

9 We draw attention to the following important points made in the Report (see sections 6 and 7 of the Report):

Non-recognition of intangible items

(a) The current accounting standards (both Australian and international) pose significant obstacles to the recognition of certain intangible items – particularly those developed internally - as intangible assets. It seems likely that businesses that deal primarily with intangible items, such as those in the spatial information industry, are disproportionately affected by this situation.

(b) As a result of the difficulty in recognising certain types of intangible items as assets, entities that rely heavily on investment in intangible items, particularly internally generated intangible items, may be significantly undervalued from a financial reporting perspective.

(c) The application of the prevailing accounting standards arguably does not accurately reflect the true value of intangible items held by entities in

knowledge working industries. Most significantly, this could result in the reduction of an entity's demonstrable value in its financial statements. If it leads to a significant understatement of the value of intangible items truly controlled and exploitable by the entity, it will reduce the relevance and reliability of information available for internal and external decision-making, decreasing the usefulness of financial reports.

(d) To give an indication of the extent of this issue, it has been estimated that the unrecorded "knowledge capital" intangibles for Microsoft were US$211 billion and for Intel, US$170 billion. (Although to put this into perspective it is worth noting the vast difference between the market capitalisation and the reported net assets of these entities.)

Value of intangible assets shown in balance sheet

(e) After initial recognition (which must be at cost), an entity may choose to carry an intangible asset at cost or fair value. However, fair value can only be used when it can be determined by reference to an 'active market'. AASB 138 states that it is uncommon for active markets to exist in relation to intangible assets (paragraph 78). AASB 138 also states that an active market cannot exist for certain types of intangible asset, including brands, patents or trade marks, because each such asset is unique (paragraph 78).

(f) Carrying an intangible asset at cost (less amortisation and impairment losses) could significantly understate the true value of the asset. For example, the development of confidential know-how concerning how to manipulate data to achieve certain useful commercial outcomes might cost relatively little, but might (if an active market for that know-how existed) be very valuable.

Different treatment of the same type of intangible assets

(g) The application of the prevailing accounting standards results in inconsistent treatment on balance sheets of the same types of intangible assets, depending upon whether they have been developed internally or acquired from an external source. The accounting standards make it easier to recognise an intangible asset acquired separately, or through a business acquisition, than it is to recognise an internally generated intangible asset.

(h) This different treatment results in similar entities with identical assets potentially being valued differently for financial reporting purposes, depending upon the model used for production and acquisition of intangible assets. This means that financial statements may lose their comparability.

Impact on relevance

(i) One of the key tenets of the Australian and international accounting standards is that they aim for entities to produce financial reports that are both relevant to the economic decision-making needs of users, and reliable. The concept of reliability comprises notions of (amongst other things) faithful representation of the financial position of the entity, prudence and completeness.

(j) The limitations discussed above may, for entities in the spatial information industry, result in financial reports that are not as relevant as they might be. The non-recognition of certain investments in intangible items might be said to distort the measurement of an entity's book value and performance. For example, omissions of capital accumulation would distort measures of productivity and earnings and diminish the predictive value of financial reports. In addition, if users of financial reports are not properly informed about the value of an entity's assets, there will be increased uncertainty and perceived risk associated with investment in the entity. (Whilst there is the opportunity to provide information on the value of an asset within the notes to the financial statements this relegation renders important information to a footnote only.)

(k) Further, if entities are unable to, or limited in their ability to, use their balance sheet to track returns on investment in intangible items, there is a risk of over- or under-investing in important areas.

Impact on reliability

(l) The issues discussed above may also impact on the reliability of the financial reports of knowledge-working entities. For example, if an entity's balance sheet does not put a value on certain intangible items that generate significant commercial benefits for the entity, arguably the information on the balance sheet is incomplete.

(m) It has been reported that some entities controlling valuable intangible items have implemented their own financial reporting systems in-house, that recognise the value in intangible items. Certain external analysts are also said to employ their own systems that recognise valuable intangible items that the accounting standards do not regard as assets. There is a danger that such analyses will be inconsistent (in relation to entities across an industry, as well as separate analyses in relation to the same entity) and this danger, as well as the inefficiency inherent in having to conduct these analyses because of perceived shortcomings in the entity's official financial reports, could perhaps be reduced if the accounting standards could be amended so that a wider range of intangible items could be recognised, and recognised at values reflecting their "real" values.

(n) Anecdotally, it would seem that the value of intangible assets in the Australian economy continues to increase. The consequences of any deficiencies in the treatment of intangible items by the accounting standards will only become more pronounced as the value of intangible assets in the economy increases.

Benefits of a fuller, more explicit treatment of intangibles on the balance sheet

(o) A fuller and more explicit treatment of intangibles in financial reporting could benefit knowledge working industries like the spatial information industry. If entities in such an industry are able to reflect the true value of the entity (including value associated with intangible items) in their financial reports, the efficiency of internal management and external investment decisions would be improved. The predictive power of financial reports in relation to such an entity might be increased, and

management and external investment decisions could proceed on a more rational basis, using relevant and reliable information.

(p) Further, a consistent treatment of the same types of intangible assets, regardless of how those assets are acquired or developed, would facilitate comparability of financial reports, allowing users to judge fairly the performance of entities against other entities within the relevant sector and between sectors.

(q) The IASB has already acknowledged the importance of these tasks. It has stated that "developing a standard for intangible assets based on conceptually sound and consistent principles could potentially result in financial statements that more faithfully represent the assets and, therefore, financial position of an entity".

Impact on investment in Research

(r) Point number 68, page 25, states that "IAS 38 prohibits recognition of internally generated intangible assets arising from 'research' and, as noted in paragraph 50 above, 'brands, mastheads, publishing titles, customer lists and items similar in substance', and requires the recognition of internally generated intangible assets arising from 'development' only in certain circumstances." There is little doubt that this approach inhibits research investment by companies. There appears to no good reason why this approach should be maintained. Research should be strongly encouraged. The mechanism by which the intangible asset comes into being should be irrelevant to its proper treatment as an asset.

Recommendations and Conclusions on the Discussion Paper

Below we make some specific comments on the Discussion Paper. Reference to paragraph numbers are to paragraphs of the Discussion Paper, unless otherwise indicated.

10 CRCSI, ASIBA and ANZLIC share the concern of those interviewed for the report, about the inconsistencies in the financial reporting treatment of intangible assets acquired in a business combination as compared with internally generated intangible assets (para. A6(g) of the Discussion Paper; paras. 4.10, 4.22, 4.29, 4.34, 4.39 and 4.40 of the Report). We support the concern attributed to Lev, that non-recognition of intangible assets may lead to higher costs of capital for early-stage knowledge-intensive entities and systematic undervaluation by investors of intangibles-intensive enterprises (para. 98 of the Discussion Paper).

11 CRCSI, ASIBA and ANZLIC support the view that considering changes to the requirements in IAS 38 for the initial accounting for internally generated intangible assets provides significant potential for improvements (para. 7).

12 We agree that internally generated intangible assets that meet the relevant asset definition and recognition criteria should be recognised in financial statements (para. 258).

13 We support the conclusion that internally generated intangible assets should be required to be initially measured at fair value to enhance the decision-usefulness of financial reports (para. 190). This would address a number of the points made in the Report, and highlighted above. We also support the conclusion that the methods and significant assumptions applied in determining the asset's fair value should be disclosed, along with reasonably possible alternative assumptions that would change the fair value significantly (para. 225). Further, we are comfortable with the conclusion that the costs readily attributable to such assets should also be disclosed (para. 232).

14 We agree that determining the fair value of an internally generated intangible asset of an entity is less onerous for the entity than determining the fair value of an intangible asset acquired in a business combination, as the entity will generally know its own assets better than those it acquires in a business combination, particularly a "hostile" acquisition (para. 154).

15 We endorse the need to amend IAS 38 and AASB 138 to give effect to the above.

Further input from CRCSI, ASIBA and ANZLIC

16 CRCSI, ASIBA and ANZLIC would be happy to consider any request for further information in support of their comments above. If further input is required, the initial contact person is Peter Woodgate, CEO of CRCSI. Peter can be contacted at:

pwoodgate@crcsi.com.au

Currency of Report and these comments

17 The attached Report, and these comments, are based on accounting standards and laws as at 25 July 2008. As the Report was produced relatively recently, we have not conducted a review of any relevant changes to accounting standards or laws that may have occurred since that date.

Peter Woodgate

CEO

CRCSI

4 May 2009

Annexure - Brief

BRIEF FOR CORRS CHAMBER WESTGARTH

PURPOSE

1. To establish the current position under Australian law and under the prevailing international accounting standards as applied in Australia that sets out how intangibles are treated on the balance sheet.

2. To seek a considered opinion that may be used publicly, on the treatment or lack thereof, of knowledge, knowledge capital, intellectual capital and people know-how in relation to the expression of their value on the balance sheet and their role in valuing the business.

ISSUES

1. The Australian Institute of Company Directors have published in their Company Directors course notes (module 3, page 49, 2007) under the heading "International Accounting Standards" the following statement:

   "*Generally only intangible assets that are acquired can be recognized as assets in the balance sheet. This means internally generated intangible assets cannot be recognized as assets. Exceptions are product development costs to the extent of reasonable assurance that the future revenues will recover the production costs and the deferred costs and the legal costs of registering patents. Thus companies with internally generated intangible assets, such as brand names, have removed them from the balance sheet by either reversing the revaluation reserve or reducing retained profits in equity.*"

   The implication of this statement is that the full and true value of intangibles particularly the intellectual property intangibles cannot be fully expressed on the balance sheet. The consequence of this in an increasingly knowledge working society is that those businesses that rely mostly on their self-generated intellectual property cannot value that intellectual property on the single most important accounting instrument available under law to value businesses.

   It has been noted; AASB 138 – Intangible Assets para 51 – 67 provides some assessment guidelines for recognising internally generated intangible assets. Suggesting an internally generated intangible asset can be recognised as an asset on the balance sheet through classifying the generation of the asset into a research and development phase, with all research costs, expensed. Can you please confirm.

2. Could you please confirm the accounting and legal treatment of intangible assets for the following is covered in AASB 138:-

- Trademarks
- Patents
- Licences
- Designs
- Copyright
- Software
- And any other terms that relate to intangibles and intellectual property that are explicitly acknowledged in the accounting standard.

3. It would also be useful to clarify the accounting and legal treatment with respect to the intangibles on the balance sheet of those other items of knowledge not explicitly referenced in the accounting standard including:

- Knowledge capital
- Intellectual capital
- Know-how
- Data
- Databases

This brief could usefully define these terms and indicate the hierarchy of relationships under intangibles and intellectual property that describes how each of these points in terms of points 2 and 3 above relate to each other.

4. Offer an opinion as to the implications, to a knowledge working industry like the spatial information industry, of the current treatment of intangibles under prevailing Australian accounting standards.

5. Provide advice as to whether a fuller and more explicit treatment of intangibles on the balance sheet would benefit a knowledge working industry like the spatial information industry.

6. Please find attached extracts from AASB 138 that deal with internally generated intangible assets. Please advise if there are any other standards which deal with intangible and intellectual property.

OUTPUTS

1. A report which covers the issues raised above.

Peter Woodgate/Samantha Bain
23 May 2008

Internally Generated Intangible Assets

51. It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in:

    (a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and

    (b) determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.

    Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an entity applies the requirements and guidance in paragraphs 52-67 to all internally generated intangible assets.

52. To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

    (a) a research phase; and

    (b) a development phase.

    Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of this Standard.

53. If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

54. No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

55. In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred.

56. Examples of research activities are:

    (a) activities aimed at obtaining new knowledge;

    (b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

    (c) the search for alternatives for materials, devices, products, processes, systems or services; and

    (d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

57. An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

    (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

    (b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

58. In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase.

59. Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

60. To demonstrate how an intangible asset will generate probable future economic benefits, an entity assesses the future economic benefits to be received from the asset using the principles in AASB 136 *Impairment of Assets*. If the asset will generate economic benefits only in combination with other assets, the entity applies the concept of cash-generating units in AASB 136.

61. Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources. In some cases, an entity demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

62. An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

63. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

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

Cost of an Internally Generated Intangible Asset

65. The cost of an internally generated intangible asset for the purpose of paragraph 24 is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria in paragraphs 21, 22 and 57. Paragraph 71 prohibits reinstatement of expenditure previously recognised as an expense.

66. The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are:

(a) costs of materials and services used or consumed in generating the intangible asset;

(b) costs of employee benefits (as defined in AASB 119) arising from the generation of the intangible asset;

(c) fees to register a legal right; and

(d) *amortisation* of patents and licences that are used to generate the intangible asset.

AASB 123 specifies criteria for the recognition of interest as an element of the cost of an internally generated intangible asset.

67. The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

(b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and

(c) expenditure on training staff to operate the asset.

Example illustrating paragraph 65

An entity is developing a new production process. During 20X5, expenditure incurred was CU1,000,[1] of which CU900 was incurred before 1 December 20X5 and CU100 was incurred between 1 December 20X5 and 31 December 20X5. The entity is able to demonstrate that, at 1 December 20X5, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be CU500.

At the end of 20X5, the production process is recognised as an intangible asset at a cost of CU100 (expenditure incurred since the date when the recognition criteria were met, i.e. 1 December 20X5). The CU900 expenditure incurred before 1 December 20X5 is recognised as an expense because the recognition criteria were not met until 1 December 20X5. This expenditure does not form part of the cost of the production process recognised in the balance sheet.

During 20X6, expenditure incurred is CU2,000. At the end of 20X6, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be CU1,900.

At the end of 20X6, the cost of the production process is CU2,100 (CU100 expenditure recognised at the end of 20X5 plus CU2,000 expenditure recognised in 20X6). The entity recognises an impairment loss of CU200 to adjust the carrying amount of the process before impairment loss (CU2,100) to its recoverable amount (CU1,900). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in AASB 136 are met.

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1 In this Standard, monetary amounts are denominated in 'currency units' (CU).

CORRS CHAMBERS WESTGARTH
lawyers

REPORT ON THE ACCOUNTING TREATMENT OF INTANGIBLE ASSETS IN AUSTRALIA

16 OCTOBER 2008

CONTENTS

THE ACCOUNTING TREATMENT OF INTANGIBLE ASSETS IN AUSTRALIA

1 Purpose of this report

1.1 This report has been prepared for Spatial Information Systems Ltd (SISL) by Corrs Chambers Westgarth (Corrs) with the assistance of Ernst & Young (EY), in response to a brief dated 23 May 2008 prepared by Peter Woodgate and Samantha Bain. SISL is the intellectual property holding company of the Cooperative Research Centre for Spatial Information (CRCSI), an unincorporated joint venture that pursues innovation and commercialisation of spatial information applications. See the Annexure for a copy of the Brief.

1.2 The purposes of this report as stated in the Brief are:

(a) to establish the current position under Australian law and under the prevailing Australian Accounting Standards (including Australian equivalents to International Financial Reporting Standards) that sets out how intangibles are treated on the balance sheet of a business engaged in the spatial information industry; and

(b) to seek a considered opinion that may be used publicly, on the treatment or lack thereof, of knowledge, knowledge capital, intellectual capital and people know-how in relation to the expression of their value on the balance sheet and their role in valuing such a business.

1.3 This report is prepared for SISL. While this report has been prepared on the understanding that SISL may disseminate copies of it for the purpose of generating discussion on the issues covered by this report, the report may not be relied on by any other person and Corrs and EY will have no liability to any third party who relies on the report.

1.4 Accounting standards and the supporting legislation are amended from time to time. This report is based on the law as at 25 July 2008. Corrs and EY take no responsibility for providing any person with any updates should any of the information in this report change after that date.

1.5 This report has been prepared in two parts:

(a) the main body of the report, which specifically addresses the issues raised in the Brief; and

(b) the Appendix, which summarises the current position in relation to the accounting treatment of intangible assets in Australia (as specified in Australian Accounting Standards and applied by Australian law).

2 Executive summary

2.1 In summary, the current Australian and international accounting standards make it difficult to recognise certain types of intangible items as assets, particularly where those items are internally developed rather than externally acquired.

2.2 AASB 138 *Intangible Assets* deals with the accounting for the majority of intangible assets. In terms of recognition, AASB 138 prescribes specific criteria for the various ways in which an intangible item may be derived. Whilst in most instances the recognition of intangible assets acquired separately or as part of a business combination is likely, internally generated items are subject to more stringent criteria which may prevent their recognition. Certain types of internally generated intangible items are prohibited from recognition in the balance sheet.

2.3 It is also important to distinguish between the initial recognition of an intangible asset and any subsequent expenditure on it, since the latter is generally required to be expensed rather than added to the carrying amount of the intangible asset.

2.4 A knowledge working industry such as the spatial information industry is limited by prevailing Australian Accounting Standards on what it can attribute value to in its financial statements. Ultimately, though, the market value of an entity in this industry will, like all other industries, be driven by factors such as projected cash flows and market demand for products or services.

RESPONSE TO ISSUES RAISED IN THE BRIEF

3 Recognition of internally generated intangible assets on the balance sheet

Issue 1: AASB 138 suggests that an internally generated intangible asset can be recognised as an asset on the balance sheet through classifying the generation of the asset into a research and development phase, with all research costs expensed. Please confirm.

3.1 This is correct. As mentioned in **section 13** of this report, to assess whether an internally generated intangible asset meets the criteria for recognition in AASB 138, it is necessary to classify the generation of the intangible asset into a research phase and a development phase (see **sections 13.8** and **13.11** for examples of what constitute research activities and development activities respectively). Expenditure in relation to the research phase must be expensed, while expenditure in relation to the development phase may be recognised as part of the cost of the intangible asset, provided it meets the criteria specified in **sections 13.10** to **13.17**.

3.2 Note, however, that AASB 138 prohibits certain internally generated items being recognised as intangible assets in the balance sheet. These include internally generated brands, mastheads, publishing titles, customer lists and items similar in substance (see **section 4** below for further discussion).

4 Accounting and legal treatment of specific intangible assets

Issue 2: Please confirm the accounting and legal treatment of certain intangible assets is covered in AASB 138.

4.1 We discuss below a range of types of intangible items, and whether they can be recognised as intangible assets under AASB 138.

4.2 AASB 138 does not generally address the specific *types* of intangible asset that may exist. As long as an asset is within the scope of AASB 138, an asset meeting certain criteria may be recognised. The criteria are:

(a) identifiability;

(b) control;

(c) existence of future economic benefits; and

(d) recognition criteria (see **section 11.1** and **section 12** for discussion of these criteria).

4.3 In addition to these general criteria, AASB 138 provides additional guidance/requirements on the application of these criteria to the various ways in which an intangible asset may be derived. For example, AASB 138 prescribes how to apply the criteria when an intangible asset is:

(a) separately acquired (for example, when an entity acquires an intangible asset from a third party in an arm's length transaction);

(b) acquired as part of a business combination (for example, when an entity acquires a controlling interest in another entity that owns an intangible asset);

(c) internally generated (for example, when an entity develops its own intangible asset); or

(d) acquired by way of a government grant.

4.4 Therefore, whether a particular intangible item may be recognised must be considered on a case-by-case basis.

4.5 We address below each of the types of intangible items listed in the Brief by referring to the general recognition criteria as well as the more specific application guidance/requirements referred to in **section 4.3 (a)**, **(b)** and **(c)** above (note, for the purpose of this report we have not considered the accounting for intangible assets acquired by way of government grants). We also address some additional categories that we have identified that we consider may be of interest.

4.6 Note that the discussion that follows deals predominantly with the initial recognition of intangible assets. That is, we focus on the time when the intangible item is separately acquired, acquired as part of a business combination or internally generated as part of a research and development project. This is significant because whilst it may be possible to capitalise the cost of the intangible asset upon its initial recognition, paragraph 20 of AASB 138 states that "only rarely will **subsequent expenditure** – expenditure incurred after the initial recognition of an acquired intangible asset or after completion of an internally generated intangible asset – be recognised in the carrying amount of an asset". The rationale for this is that the nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it. Accordingly most subsequent expenditures are likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria in AASB 138.

Trade marks

4.7 Most companies, including those operating in the spatial information industry, would own registered or unregistered trade marks to some extent, e.g. rights in relation to their company name or the brands used in connection with particular products or services.

4.8 Provided the criteria can be met in each case we see little difficulty in recognising trade marks that are either separately acquired or acquired in a business combination (i.e. an acquisition of a business). AASB 138 states that the fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be recognised separately from goodwill (paragraph 35). An acquirer recognises the intangible asset even if the business acquired did not recognise the asset before the business combination. The fair value allocated to the asset is its cost in the acquisition. If an purchase price has been allocated to a trade mark in connection with the acquisition, it seems likely that the trade mark will meet all of the criteria for its recognition as an intangible asset.

4.9 AASB 138 stipulates that *internally generated brands* must not be recognised as intangible assets, as they cannot be distinguished from the cost of developing the business as a whole. The reference to "brands" would appear to apply to both registered and unregistered trade marks; in paragraph 37, AASB 138 describes "brands" as a broader concept than "trademarks".

4.10 In the case of trade marks (brands) therefore, a different accounting treatment arises depending on the derivation of the asset. To the extent that the trade mark is separately acquired or acquired in a business combination it is capable/required to be recognised as an intangible asset on the balance sheet. On the other hand, if it is internally generated, all costs associated with its development must be expensed.

Patents and registered designs

4.11 We understand that companies in the spatial information industry own numerous patents that they regard as highly valuable.

4.12 Provided the criteria can be met in each case we see little difficulty in recognising patents and designs that are either separately acquired or acquired in a business combination. If a purchase price has been allocated to a patent in connection with its acquisition, it seems likely that the patent will meet the criteria for its recognition as an intangible asset.

4.13 We also consider that there will often be little difficulty in recognising patents and registered designs that are internally generated, as both seem to fit within the 'development' phase rather than the 'research' phase of a project and we expect that they would, in many cases, fit the criteria listed in **section 12** and **section 13.10**. This is because patents and designs are usually used to protect the manifestation (or application) of research or design work that has already been completed (at least up to a stage where a statutory monopoly for it can be claimed), rather than being aimed at obtaining new knowledge.

Licences

4.14 We understand that many companies in the spatial information industry rely heavily on licences they have obtained to use data owned by third parties (in many cases, owned by government entities).

4.15 Licences for an entity to use certain rights owned by a third party will always involve another entity that either owns the necessary subject matter, or licenses that subject matter from the relevant rights holder. A licence cannot be 'internally generated'.

4.16 Therefore, we see little difficulty in an entity recognising licences on its balance sheet, so long as the entity can demonstrate the relevant criteria applying to intangible assets that are separately acquired or acquired in a business combination. Where a licence fee applies (as we would expect in most cases), it seems likely that the licence will meet the criteria for its recognition as an intangible asset.

4.17 AASB 138 appears to accept that a licence may be an intangible asset (paragraph 119).

Copyright

4.18 In the spatial information industry, copyright is a very important category of intangible item. For example, a company in this industry may own copyright in

a data set that it has compiled from various sources, or in a piece of computer software developed by the company.

4.19 Provided the criteria can be met in each case we see little difficulty in recognising copyright either separately acquired or acquired in a business combination. If a purchase price has been allocated to a copyright in an acquisition, we expect that the copyright will probably meet the requirements for recognition as an intangible asset.

4.20 The Copyright Act 1968 recognises copyright as personal property that is capable of assignment (s. 196(1)) and defines copyright as the exclusive right to do particular acts, e.g. to reproduce the relevant work. Given this, we would expect that internally generated copyright items would meet the "identifiability" and "control" requirements (see **sections 12.5 to 12.7**). Indeed, AASB 138 (in paragraph 14) indicates that copyright may confer the requisite degree of "control" over the item in question. In many cases, we would expect future economic benefits to flow from copyright, and that the costs of developing a copyright item could be measured reliably. AASB 138 suggests that the cost of securing copyright could include salary and other expenditure (paragraph 62).

4.21 However, in relation to internally generated copyright, there may be a serious question over whether the copyright relates to research or to development. For example, copyright would subsist in internal reports canvassing potential markets for the out-licensing of data sets or computer software, and in the data and software themselves. The initial costs of creating those copyright materials would be viewed as research costs (or costs incurred during the research phase) that must be treated as expenses. However once a potential customer has or customers have been identified for a particular data set or piece of software, and the data set or software has been sufficiently developed that it is clear that the item can be finalised and out-licensed, then (provided the other criteria in **section 13.10** can be met), it is likely that the cost of copyright in the data set or software can be capitalised as part of the intangible asset arising from the development of the data set or software.

4.22 In the case of copyright therefore, a different accounting treatment arises depending on the derivation of the copyright material. To the extent that the copyright material is separately acquired or acquired in a business combination it is capable/required to be recognised as an intangible asset on the balance sheet. On the other hand, if the copyright material is developed internally, the accounting treatment of the cost of copyright will depend on whether the development of the material itself meets the specified recognition criteria for internally generated intangible assets. For example, one must look at whether the project is considered to be in the development phase and whether the recognition criteria for development costs (see **section 13.10**) are considered to be met.

4.23 Should the value of copyright be seen to exceed its cost, such that it could be valued using an income-based valuation methodology, there is a practical difficulty. This difficulty is the ability to support views on the proportion of revenue and earnings of the business utilising the copyright, between copyright and the other assets of the business. Unless detailed supporting material such as studies of buying behaviour are available, a value may be precluded from attributing any greater value to copyright than its cost.

Software

4.24 Provided the criteria can be met in each case we see little difficulty in recognising software either separately acquired or acquired in a business combination. If a purchase price has been allocated to software in an acquisition, we expect that the software will probably meet the requirements for recognition as an intangible asset.

4.25 Software generated internally may be recognised as an intangible asset. As outlined above, the copyright in computer software will be capable of classification as an intangible asset once the software is sufficiently developed to treat it as being in the "development" (as opposed to "research") phase. However, difficulty arises in classifying expenditure in relation to either the research or development phase of a software development project. The ACT Government's Policy Summary for AASB 138 (see http://www.treasury.act.gov.au/accounting/download/IAS_01c.pdf) provides some useful analysis of the specific types of expenditure that may be incurred in connection with internally developed software, and whether they occur in the research phase (and must be expensed) or in the development phase (and may be capitalised).

4.26 AASB 138 suggests that the cost of developing computer software could include salary and other expenditure (paragraph 62).

4.27 AASB 138 provides that where computer software is contained in or on a physical disk or other physical substance, an entity uses judgement to assess whether the tangible or intangible element is more significant (and classifies the asset accordingly). In many, if not most, cases we would expect the software to be more valuable than the medium it is stored on.

4.28 AASB 138 further provides that computer software that is the operating system of a computer, or that is for a computer-controlled machine tool that cannot operate without that software, is an integral part of that hardware and is treated as property, plant and equipment.

4.29 In the case of software therefore, a different accounting treatment arises depending on the derivation of the software. To the extent that the software is separately acquired or acquired in a business combination it is capable/required to be recognised as an intangible asset on the balance sheet. On the other hand, if the software is developed internally, the accounting treatment will depend on whether the specified recognition criteria for internally generated intangible assets are met. For example, it will be important to examine whether the project is in the development phase and whether the recognition criteria for development costs (see **section 13.10**) are met.

Customer lists

4.30 A customer list consists of information about customers, such as their names, contact information, order history and demographic information.

4.31 Provided the criteria can be met in each case we see little difficulty in recognising customer lists that have been separately acquired from a third party.

4.32 In the case where a customer list is acquired as part of a business combination, it is necessary to consider whether the customer list satisfies the

identifiability criteria in order to meet the definition of an intangible asset (see **sections 12.5** and **12.6** below). Generally a customer list does not arise from contractual or other legal rights and therefore the contractual/legal criterion for identification as an intangible asset is not met. On the other hand, in certain industries customer lists are frequently leased or exchanged, in which case the separability criterion for identification as an intangible asset is satisfied. However, as discussed in the Illustrative Examples to AASB 3 *Business Combinations,* a customer list acquired in a business combination would not meet that criterion if the terms of confidentiality or other agreements prohibit an entity from selling, leasing or otherwise exchanging information about its customers.

4.33 Paragraph 63 of AASB 138 states that 'internally generated ... customer lists and items similar in substance' may not be recognised as intangible assets.

4.34 In the case of customer lists therefore, a different accounting treatment arises depending on the derivation of the customer list. To the extent that the customer list is separately acquired or acquired in a business combination it may be capable/required to be recognised as an intangible asset on the balance sheet. On the other hand, if it is internally generated, all costs associated with its development must generally be expensed.

Confidential information

4.35 Confidential information expressed in a material form (e.g. a written report setting out the information or computer software that incorporates the information) will often be the subject of copyright, and may therefore be capable of recognition as an intangible asset – see the discussion on copyright above. However, in many cases copyright will be insufficient to protect confidentiality, as copyright generally does not prevent a third party expressing the same ideas in a different manner. Whether confidential information in a material form can be recognised as an intangible asset will therefore be subject to similar considerations as confidential information not in a tangible form – discussed below.

4.36 Confidential information that has not been reduced to a tangible form, such as knowledge of processes within an organisation or knowledge of confidential formulae (i.e. within the heads of the staff), may be capable of recognition as an intangible asset if it is protected by legal agreements, e.g. confidentiality agreements with staff, that give the entity the requisite degree of "identifiability" and "control" over the asset. AASB 1138 recognises (at paragraph 14) that market and technical knowledge may give rise to future economic benefits that are controlled through legal obligations of confidentiality. Of course, the probability of economic benefits flowing to the entity from the confidential information would need to be assessed in each case, and whether the cost of the information can be measured reliably may be problematic in some cases (particularly in the case where the confidential information has been internally generated and it is necessary to classify the generation of the asset into a research phase and a development phase and only costs in the development phase are capable of being capitalised).

4.37 Consistent with the treatment of subsequent expenditure on intangible assets (see **section 4.6** above), any practical measures the entity uses to preserve confidentiality, e.g. training and internal policies designed to reinforce the importance of maintaining confidentiality, would not be capable of being

capitalised in the carrying amount of any intangible asset that may have been recognised in relation to the confidential information itself (in other words the cost of such activity would be expensed).

4.38 It is important to distinguish between confidential information of an entity, and the talents and skills of the staff of the entity. An entity usually has insufficient control over the expected economic benefits arising from a team of skilled staff, for staff skills to be considered an intangible asset (paragraph 15 AASB 138). Similarly, specific management or technical talent is unlikely to be an intangible asset; even where contracts are in place to secure the benefit of those talents, in our view the enforceability of such contracts is problematic and as a result, the "control" element is insufficient.

4.39 In the case of confidential information therefore, a different accounting treatment arises depending on the derivation of the confidential information. To the extent that the information is separately acquired or acquired in a business combination it may be capable/required to be recognised as an intangible asset on the balance sheet. On the other hand, if the information is developed internally, the accounting treatment will depend on whether the specified recognition criteria for internally generated intangible assets are met. For example, one would consider whether the project is in the development phase and whether the recognition criteria for development costs (see **section 13.10**) are met.

Closing Observations

4.40 AASB 138 deals with the accounting for the majority of intangible assets. In terms of recognition, AASB 138 prescribes specific criteria for the various ways in which an intangible item may be derived. Whilst in most instances the recognition of intangible assets acquired separately or as part of a business combination is likely, internally generated items are subject to more stringent criteria which may prevent their recognition. Certain types of internally generated intangible items are prohibited from recognition in the balance sheet.

4.41 It is also important to distinguish between the initial recognition of an intangible asset and any subsequent expenditure on it, since the latter is generally required to be expensed rather than added to the carrying amount of the intangible asset.

5 Accounting treatment and legal treatment of items relevant to a knowledge working industry

Issue 3: Please clarify the accounting and legal treatment with respect of certain other items not referred to in AASB 138.

Please also define these terms and indicate how these terms relate to each other and to the terms identified above.

5.1 Again, whether a particular intangible item may be recognised as an intangible asset must be considered on a case-by-case basis.

5.2 As there are no specific requirements in relation to these items in AASB 138, each of the recognition criteria should be considered for each item.

Knowledge capital, intellectual capital and know-how

5.3 Knowledge capital can be defined as:

Know-how resulting from the experience, information, knowledge, learning and skills of the employees of an organisation. It may consist entirely of technical information (such as in chemical or electronics industries) or may reside in the actual experience or skills acquired by individuals (such as in construction and steel industries).

5.4 Intellectual capital can be defined as:

The total knowledge within an organisation that may be converted into value, or used to produce a higher value asset. This term embodies the knowledge and expertise of employees; brands; customer information and relationships; internal processes; methods and technologies; and intellectual property.

5.5 Know-how can be defined as:

The technical knowledge and skill required by an organisation to do something, that may be information in the form of unpatented inventions, formulae, designs, drawings, procedures and methods, together with accumulated skills and experience of an organisation's personnel, which provides a competitive advantage to the organisation.

5.6 The above are working definitions that we have selected, and are not reflective of any "official" definitions in the accounting standards or elsewhere.

5.7 As can be seen from the above definitions, there is some overlap between them.

5.8 The discussion starting at **section 4.35** in relation to confidential information applies to these terms. As a general proposition, knowledge capital, intellectual capital and know-how that are protected by enforceable legal rights (e.g. confidentiality agreements with staff) will be more likely to be capable of being recognised by an entity as intangible assets.

5.9 In the case of knowledge capital, intellectual capital and know-how therefore, a different accounting treatment arises depending on the derivation of the item. To the extent that the information is separately acquired or acquired in a business combination it may be capable/required to be recognised as an intangible asset on the balance sheet. On the other hand, if it is developed internally, the accounting treatment will depend on whether the specified recognition criteria for internally generated intangible assets are met. For example, it will be important to determine whether the project is considered to be in the development phase and whether the recognition criteria for development costs (see **section 13.10**) are met.

5.10 It will also be necessary to distinguish between the initial recognition of the intangible asset and subsequent expenditure in order to maintain the expected future economic benefits associated with the asset. This is because as discussed in **section 4.6** above, the latter is generally expensed.

Data and databases

5.11 Data refers to a collection of information in an organised manner.

5.12 A database is a collection of logically related data, electronically stored or presented, in a standardised format and searchable in a variety of ways.

5.13 Once again, the definitions we have given above are not authoritative.

5.14 Data and databases are typically represented in a physical form, e.g. in an electronic document or file. In many cases, copyright will subsist in a set of data or a database. The discussion of copyright starting at **section 4.18** applies. In many cases, data and databases may be confidential in which case the discussion starting at **section 4.35** in relation to confidential information also applies.

5.15 Again, it is necessary to distinguish between the initial recognition of the intangible asset and subsequent expenditure in order to maintain the expected future economic benefits associated with the asset because the latter is generally expensed (see **section 4.6** above).

5.16 This becomes particularly relevant with regard to data and databases. For example, an entity may have developed a service offering that involves the provision of information to a subscriber base. The entity would consider the application of AASB 138 to the cost of developing the service offering. The entity would necessarily classify the generation of the service offering into a research phase and a development phase. Costs incurred during the research phase (such as the costs involved in searching for, evaluating and selecting the service offering to pursue) would be required to be expensed. Costs incurred during the development phase (such as the design of the service offering and the initial collection of data to enable the service offering) would be capable of being capitalised as an intangible asset if the criteria set out in **section 13.10** below are met. At the time the entity commences the service offering the development phase is complete. Any subsequent expenditure incurred by the entity would need to be considered in terms of whether it meets the recognition criteria for an intangible asset or whether it is merely maintaining the expected future economic benefits from the intangible asset. For example, costs incurred to collect, analyse and store new data in order to keep the service offering up-to-date would be viewed as subsequent expenditure to maintain the asset and would therefore be expensed. On the other hand, if the entity sought to expand the service offering (such as introduce new features such that the original service offering is significantly improved) then the costs of this expansion may be capitalised if the recognition criteria in **section 13.10** are met.

5.17 The accounting for subsequent expenditure referred to above would apply regardless of whether the entity internally generated the service offering (as described above) or if it had separately acquired the service offering from a third party or acquired it as part of a business combination.

Closing Observations

5.18 The observations made in **sections 4.40** and **4.41** above are equally applicable here.

6 Implications to a knowledge working industry of the current treatment of intangibles

Issue 4: Offer an opinion as to the implications, to a knowledge working industry like the spatial information industry, of the current treatment of intangibles under prevailing Australian accounting standards.

6.1 There are a number of important implications to a knowledge-working industry, like the spatial information industry, arising from the prevailing accounting standards in connection with intangible items.

Non-recognition of intangible items

6.2 The current accounting standards (both Australian and international) pose significant obstacles to the recognition of certain intangible items – particularly those developed internally - as intangible assets. This has important ramifications for entities whose businesses focus on working with and developing intangible assets. It seems likely that businesses that deal primarily with intangible items, such as knowledge working industries, are disproportionately affected by this situation.

6.3 As a result of the difficulty in recognising certain types of intangible items as assets, entities that rely heavily on investment in intangible items (particularly internally generated intangible items) such as knowledge capital and intellectual capital may be significantly undervalued from a financial reporting perspective, as the value of those assets may be omitted from its financial reports. Ultimately, though, the market value of these entities will be driven by factors such as projected cash flows and market demand for these entities' products and services.

6.4 Entities in a range of industries (not just knowledge working industries) have also used the notes on intangible assets in their financial statements to disclose independent valuations or management valuations of those assets, even when those values have not been recognised in the balance sheet. This is one way for an entity to convey information on value to stakeholders and potential investors despite the requirements of accounting standards.

6.5 The International Accounting Standards Board (**IASB**) stated in December 2007 that many of the basic principles reflected in IAS 38 (AASB 138) can be traced back to an Exposure Draft in relation to accounting for research and development costs, which was issued by the IASC (predecessor to the IASB) for comment on 1 February 1977. The IASB stated further that it is timely that IAS 38 is subject to *fundamental* review, particularly given the increased significance being placed on intangible assets.[1]

6.6 The application of the prevailing accounting standards arguably does not accurately reflect the true value of intangible items held by entities in knowledge working industries. Most significantly, this could result in the reduction of an entity's demonstrable value in its financial statements. If it leads to a significant understatement of the value of intangible items truly controlled and exploitable by the entity, it will reduce the relevance and reliability of information available for internal and external decision-making, decreasing the usefulness of financial reports. In practice, though, potential investors are likely to consider a number of information sources in order to formulate their investment decision, not just the financial report.

6.7 To give an indication of the extent of this issue, it has been estimated that the unrecorded "knowledge capital" intangibles for Microsoft were US$211 billion and for Intel, US$170 billion.[2] (Although to put this into perspective it is worth noting the vast difference between the market capitalisation and the reported net assets of these entities.)

Value of intangible assets shown in balance sheet

6.8 After initial recognition (which must be at cost), an entity may choose to carry an intangible asset at cost or fair value. However, fair value can only be used when it can be determined by reference to an 'active market'. AASB 138 states that it is uncommon for active markets to exist in relation to intangible assets (paragraph 78). AASB 138 also states that an active market cannot exist for certain types of intangible asset, including brands, patents or trade marks, because each such asset is unique (paragraph 78).

6.9 Carrying an intangible asset at cost (less amortisation and impairment losses) could significantly understate the true value of the asset. For example, the development of confidential know-how concerning how to manipulate data to achieve certain useful commercial outcomes might cost relatively little, but might (if an active market for that know-how existed) be very valuable.

Different treatment of the same type of intangible assets

6.10 The application of the prevailing accounting standards results in inconsistent treatment on balance sheets of the same types of intangible assets, depending upon whether they have been developed internally or acquired from an external source. As indicated above, the accounting standards make it easier to recognise an intangible asset acquired separately, or through a business acquisition, than it is to recognise an internally generated intangible asset.

6.11 This different treatment results in similar entities with identical assets potentially being valued differently for financial reporting purposes, depending upon the model used for production and acquisition of intangible assets. This means that financial statements may lose their comparability.

Impact on relevance

6.12 One of the key tenets of the Australian and international accounting standards is that they aim for entities to produce financial reports that are both relevant to the economic decision-making needs of users, and reliable. The concept of reliability comprises notions of (amongst other things) faithful representation of the financial position of the entity, prudence and completeness.

6.13 The limitations discussed above may, for entities in the spatial information industry, result in financial reports that are not as relevant as they might be. The non-recognition of certain investments in intangible items might be said to distort the measurement of an entity's book value and performance. For example, omissions of capital accumulation would distort measures of productivity and earnings and diminish the predictive value of financial reports. In addition, if users of financial reports are not properly informed about the value of an entity's assets, there will be increased uncertainty and perceived risk associated with investment in the entity. On the other hand, there is the opportunity to provide information on the value of an asset within the notes to the financial statements. In other words, whilst an entity may be prohibited from recognising a value for a strategically significant intangible item in its

balance sheet, it is not necessarily precluded from providing such information by way of a note disclosure in its financial report.

6.14 Further, if entities are unable to, or limited in their ability to, use their balance sheet to track returns on investment in intangible items, there is a risk of over- or under-investing in important areas.

6.15 Of course, the above criticisms of the present accounting standards will ultimately only be sustainable if it can be shown that specific changes to the standards could be made, to allow recognition of intangible assets in a more "relevant" manner (and whilst maintaining "reliability"). It is beyond the scope of this report to explore the specific changes that could be made.

Impact on reliability

6.16 The issues discussed above may also impact on the reliability of the financial reports of knowledge-working entities. For example, if an entity's balance sheet does not put a value on certain intangible items that generate significant commercial benefits for the entity, arguably the information on the balance sheet is incomplete. (Weighing against this argument is the need for prudence in financial reporting.)

6.17 Given the perceived limits on the relevance and reliability of information in relation to intangible assets, particularly internally generated intangible assets, available under existing accounting standards, some commentators have suggested that a parallel system for intangible assets should be created.

6.18 It has also been reported that some entities controlling valuable intangible items have implemented their own financial reporting systems in-house, that recognise the value in intangible items that the accounting standards do not permit to be recognised as assets. Certain external analysts are also said to employ their own systems that recognise valuable intangible items that the accounting standards do not regard as assets. There is a danger that such analyses will be inconsistent (in relation to entities across an industry, as well as separate analyses in relation to the same entity) and this danger, as well as the inefficiency inherent in having to conduct these analyses because of perceived shortcomings in the entity's official financial reports, could perhaps be reduced if the accounting standards could be amended so that a wider range of intangible items could be recognised, and recognised at values reflecting their "real" values. Whether it would be possible to amend the accounting standards so that these outcomes can, with integrity, be achieved may require further exploration.

6.19 Anecdotally, it would seem that the value of intangible assets in the Australian economy continues to increase. The consequences of any deficiencies in the treatment of intangible items by the accounting standards will only become more pronounced as the value of intangible assets in the economy increases.

Closing Observations

6.20 A knowledge working industry such as the spatial information industry is limited by prevailing Australian Accounting Standards in relation to the items to which it can attribute value in its financial statements. Ultimately, though, the market value of an entity in this industry will, like all other industries, be driven by factors such as projected cash flows and market demand for products or services.

7 Whether a fuller and more explicit treatment of intangibles on the balance sheet would benefit a knowledge working industry

Issue 5: Provide advice as to whether a fuller and more explicit treatment of intangibles on the balance sheet would benefit a knowledge working industry like the spatial information industry.

7.1 A fuller and more explicit treatment of intangibles in financial reporting could benefit knowledge working industries like the spatial information industry. If entities in such an industry are able to reflect the true value of the entity (including value associated with intangible items) in their financial reports, the efficiency of internal management and external investment decisions would be improved. The predictive power of financial reports in relation to such an entity might be increased, and management and external investment decisions could proceed on a more rational basis, using relevant and reliable information.

7.2 Further, a consistent treatment of the same types of intangible assets, regardless of how those assets are acquired or developed, would facilitate comparability of financial reports, allowing users to judge fairly the performance of entities against other entities within the relevant sector and between sectors.

7.3 The IASB has already acknowledged the importance of these tasks. It has stated that "developing a standard for intangible assets based on conceptually sound and consistent principles could potentially result in financial statements that more faithfully represent the assets and, therefore, financial position of an entity".[3]

7.4 Whether it is possible to change the accounting standards to achieve the above outcomes, while preserving the objectives of relevance and reliability of financial reporting, may be a topic for further consideration.

8 Other applicable standards

Issue 6: Please advise if there are any other standards which deal with intangible and intellectual property.

8.1 As mentioned in **section 10.4**, some intangible assets are not within the scope of AASB 138. These relate to quite specific types of intangible asset.

8.2 In addition, some other standards complement AASB 138 and help inform its application. These include:

(a) AASB 1031 *Materiality*;

(b) AASB 1048 Interpretation and Application of Standards;

(c) AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors;

(d) AASB 136 *Impairment of Assets* (in relation to an intangible asset's carrying amount);

(e) AASB 123 *Borrowing Costs* (in relation to the treatment of borrowing costs used to develop an intangible asset);

(f) AASB 3 *Business Combinations* (in relation to the treatment of intangible assets acquired in a business combination); and

(g) UIG Interpretation 132 Intangible Assets – Web Site Costs.

APPENDIX – CURRENT ACCOUNTING TREATMENT OF INTANGIBLE ASSETS IN AUSTRALIA

9 Financial reports

9.1 Part 2M.3 of the *Corporations Act* 2001 (Cth) (**Corporations Act**) requires certain entities to prepare a financial report for each financial year.[4] Those entities include all public companies and all large proprietary companies.[5] In some circumstances, small proprietary companies[6] may also be required to, or may choose to, prepare a financial report. The financial report must include financial statements as required by the relevant accounting standards [7].

9.2 The Australian Accounting Standards Board (**AASB**) makes accounting standards for the purposes of the Corporations Act.

10 Accounting Standard AASB 138 *Intangible Assets*

10.1 AASB 138 *Intangible Assets* was issued on 15 July 2004 by the AASB and came into effect for reporting periods beginning on or after 1 January 2005. Apart from some additional sections added by the AASB (which are limited and are not central to this report), AASB 138 is equivalent to International Accounting Standard IAS 38 *Intangible Assets*.

10.2 For-profit entities that comply with the requirements of AASB 138 (as amended) will simultaneously be in compliance with the requirements of IAS 38 (as amended).[8]

10.3 AASB 138 applies to:

(a) each entity required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act (see **9.1** above) and that is a reporting entity;[9]

(b) general purpose financial reports of each other reporting entity; and

(c) financial reports that are, or are held out to be, general purpose financial reports.

10.4 AASB 138 covers *all* intangible assets, except:

(a) intangible assets that are within the scope of another Australian Accounting Standard, including:

(i) intangible assets held by an entity for sale in the ordinary course of business (AASB 102 and AASB 111);

(ii) deferred tax assets (AASB 112);

(iii) leases within the scope of AASB 117;

(iv) assets arising from employee benefits (AASB 119);

(v) goodwill acquired in a business combination[10] (AASB 3);

(vi) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of AASB 4 *Insurance Contracts*;

(vii) intangible assets classified as held for sale (AASB 5);

(b) financial assets (AASB 132 Financial Instruments: Presentation);

(c) exploration and evaluation assets in connection with mineral resources (e.g. drilling rights) (AASB 6); and

(d) expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources.[11]

11 Types of intangible assets that may be recognised

When an intangible asset can be recognised

11.1 AASB 138 sets out criteria that must be satisfied before an intangible item can be recognised as an intangible asset and stated on an entity's balance sheet. These criteria are:

(a) identifiability;

(b) control;

(c) existence of future economic benefits; and

(d) recognition criteria.

11.2 An entity may recognise an intangible asset if, and only if, the above criteria are met.[12]

11.3 If an item within the scope of AASB 138 *does not* satisfy the above criteria, the expenditure to acquire it or generate it internally must be recognised as an expense when it is incurred,[13] unless the item is acquired in a business combination.

11.4 If the item does not satisfy the above criteria and is acquired in a business combination, the expenditure on the item forms part of the amount attributed to goodwill at the acquisition date.[14]

Types of recognisable intangible asset that may exist

11.5 Generally, AASB 138 does not address the specific *types* of intangible asset that may exist. As long as an asset is within the scope of AASB 138, an asset meeting the criteria specified at **11.1** above may be recognised.

11.6 However, certain types of intangible assets cannot be recognised on an entity's balance sheet. Expenditure on these *must* be recognised as an expense when incurred. These fall into three main categories:

(a) internally generated brands, mastheads,[15] publishing titles, customer lists and items similar in substance;[16]

(b) expenditure in relation to start-up activities, training activities, advertising and promotional activities and relocating or reorganising part or all of an entity;[17] and

(c) expenditure on the research phase of an internal project.[18]

12 Criteria for recognition of an intangible asset

Definitions

12.1 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.

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

12.3 Therefore, an intangible item must meet the requirements of identifiability, control over a resource and existence of future economic benefits in order to be defined as an intangible asset.

12.4 Further, the item must meet the 'recognition criteria' specified in paragraphs 21 to 23 of AASB 138.

Identifiability

12.5 Identifiability is the characteristic that conceptually distinguishes intangible assets from goodwill.

12.6 An asset is identifiable when it:

(a) is separable (capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, individually or together with a related contract, asset or liability); or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Control

12.7 An entity controls an asset if it has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. While this capacity to control would normally stem from enforceable legal rights, control may be shown without such rights. [19]

Existence of future economic benefits

12.8 The future economic benefits may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity.

Recognition criteria

12.9 Paragraph 21 AASB 138 states that 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.

12.10 Paragraph 22 provides that an entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

12.11 Paragraph 23 provides that an entity uses judgement to assess this degree of certainty on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

12.12 The recognition criteria are generally easily satisfied in relation to intangible assets that are either acquired as part of a business combination[20] or separately acquired.[21]

12.13 Significant difficulty arises in applying the recognition criteria to internally generated intangible assets. This is discussed in further detail below.

12.14 An intangible asset must be derecognised on disposal, or when no future economic benefits are expected from its use or disposal (paragraph 112).

13 Recognition of internally generated intangible assets

13.1 Paragraphs 48 and 49 AASB 138 provides that internally generated goodwill shall not be recognised as an asset, as it is not considered an identifiable resource controlled by the entity that can be measured reliably at cost.

13.2 However, some types of internally generated intangible assets other than goodwill *can* be recognised by an entity if they can be characterised as resulting from research and development, and certain criteria are met as outlined below.

Classification: research or development?

13.3 In addition to complying with the general requirements for recognition and initial measurement of an intangible asset, internally generated intangible assets must meet the criteria in paragraphs 52 to 67 of AASB 138 before being recognised.[22]

13.4 An entity must classify the generation of the asset into two phases: a research phase and a development phase.

13.5 Research is 'original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding'.[23]

13.6 Development, on the other hand, is 'the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use'.[24]

Treatment of expenditure on research

13.7 No intangible asset arising from research, or the research phase of an internal project, may be recognised. Expenditure on research must instead be recognised as an expense when incurred.[25]

13.8 AASB 138 identifies some examples of research activities. These are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives.[26]

Treatment of expenditure on development

13.9 On the other hand, an intangible asset arising from development, or the development phase of an internal project, may be recognised.

13.10 Before any such asset may be recognised, an entity must demonstrate **all** of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits;

(e) the availability of adequate technical, financial and other resources to complete the development and use or sell the intangible asset; and

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.[27]

13.11 AASB 138 identifies some examples of development activities. These are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.[28]

13.12 If an entity cannot distinguish the research phase from the development phase, the entity must treat the expenditure *as if it were incurred in the research phase only*.[29]

Cost base of an internally generated intangible asset

13.13 Once an intangible asset has been recognised, it must be accounted for using the cost model (where the asset is carried at its cost less any accumulated amortisation and less any accumulated impairment losses) or the revaluation model (where the asset is carried at a revalued amount, being its fair value at the date of revaluation less any accumulated amortisation and less any accumulated impairment losses, and with revaluations being made regularly).[30]

13.14 The cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria (see **13.10** above).[31] That is, the cost includes expenditure incurred once the item can be classified as switching from the 'research phase' to the 'development phase'.

13.15 This cost comprises all *directly attributable* costs necessary to create, produce and prepare the asset to be capable of operating in the manner intended by management.[32]

13.16 Examples of components that are not directly attributable include:

(a) general selling, administrative and other overhead expenditure;

(b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and

(c) expenditure on training staff to operate the asset.[33]

13.17 Expenditure on an intangible item that was initially treated as an expense must not be recognised as part of the cost of an intangible asset at a later date, i.e. it cannot be re-classified once an intangible asset has been recognised.[34]

14 Other matters dealt with in AASB 138

14.1 In addition to initial recognition of intangible assets, AASB 138 also deals with amortisation of intangible assets, disposal of intangible assets and the disclosures required (e.g. disclosure of gross carrying amount and any accumulated amortisation) in relation to intangible assets.

Notes

[1] However, the IASB stated that 'properly addressing the accounting for intangible assets would impose a large demand on the Board's limited resources'. As a result, the IASB decided not to add a project on intangible assets to its active agenda. See Paragraphs 8-10 of IASB's Project Update: Intangible Assets (December 2007) (IASCF).

[2] The Measurement and Recognition of Intangible Assets, Siegel and Borgia, Journal of Business and Public Affairs, Vol 1 Issue 1 2007. Note that Microsoft and Intel apply US GAAP in the preparation and presentation of their financial reports (i.e. not International Financial Reporting Standards). However, US GAAP is also restrictive in terms of recognising value attributable to an entity's intangible assets.

[3] Paragraph 10 of IASB's Project Update: Intangible Assets (December 2007) (IASCF).

[4] Section 292(1) Corporations Act.

[5] Section 45A(3) of the Corporations Act defines large proprietary companies as proprietary companies that satisfy any two of the following conditions:

- consolidated gross operating revenue for the financial year of at least $10 million (including the entities it controls);
- consolidated gross assets at the end of the financial year of at least $5 million (including the entities it controls); and
- at least 50 employees at the end of the financial year (including the entities the company controls).

[6] Section 45A(2) of the Corporations Act effectively defines small proprietary companies as those that do not fall within note 4.

[7] Section 295 of the Corporations Act.

[8] See AASB 138, page 7.

[9] A 'reporting entity' is an organisation which is obliged to prepare general-purpose financial reports complying fully with accounting standards. This obligation arises when users of financial information depend on the reports for the information they need in making financial decisions, but are unable to command specific information from the organisation. Although there is some debate among accountants, it is generally the existence of these 'dependent users' that determines whether the organisation is a reporting entity.

[10] A business combination is a 'transaction or other event in which an acquirer obtains control of one or more businesses': AASB 3.

[11] Paragraph 2 AASB 138.

[12] Paragraph 1 AASB 138.

[13] Paragraphs 10 and 68 AASB 138.

[14] Paragraphs 10 and 68 AASB 138.

[15] Mastheads are a block of information, including staff names and publication data, used in print media to identify the location, ownership and management of newspapers and magazines.

[16] Paragraph 63 AASB 138. The International Accounting Standards Committee (**IASC**) considered that internally generated intangible items of this kind would rarely meet the 'recognition' criteria in IAS 38. The IASC decided to set these out in the form of an explicit prohibition 'to avoid any misunderstanding': Paragraph BCZ45, IAS 38 - Intangible Assets: Basis for Conclusions (IASCF).

[17] Paragraph 69 AASB 138. The IASC stated that the requirement to recognise expenditure on these activities as an expense is based on the IASC's interpretation of the 'recognition' criteria in IAS 38, and reflects the fact that 'it is sometimes difficult to determine whether there is an internally generated intangible asset distinguishable from internally generated goodwill': Paragraph BCZ46, IAS 38 - Intangible Assets: Basis for Conclusions (IASCF).

[18] Paragraph 54 AASB 138. Paragraph 55 AASB 138 states that, in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits.

[19] Paragraph 13 AASB 138.

[20] See paragraphs 33 to 43 AASB 138.

[21] See paragraphs 25 to 32 AASB 138.

[22] See paragraph 51 AASB 138.

[23] See paragraph 8 AASB 138.

[24] See paragraph 8 AASB 138.

[25] See paragraph 54 AASB 138.

[26] See paragraph 56 AASB 138.

[27] See paragraph 57 AASB 138.

[28] See paragraph 59 AASB 138.

[29] See paragraph 53 AASB 138.

[30] Paragraphs 72 to 75 AASB 138.

[31] See paragraph 65 AASB 138.

[32] See paragraph 66 AASB 138.

[33] See paragraph 67 AASB 138.

[34] See paragraph 71 AASB 138.