20. Intangibles

The defining characteristic of an intangible is the lack of physical existence. Nevertheless, such assets contribute to the earnings capability of a company. Examples include patents, copyrights, trademarks, brands, franchises, and similar items. A company develops many such items via ongoing business processes, and those internally developed intangibles may not appear on the corporate accounts. For example, GAAP prohibits recording research and development expenditures as assets; nevertheless, significant intangible rights and benefits may emanate from such activities. Those intangible benefits represent an invisible asset of the company.

On the other hand, intangibles may be purchased from another party. For example, one company may need to utilize technology embedded in a patent right belonging to someone else. When intangibles are purchased, the cost is recorded as an intangible asset. When a purchased intangible has an identifiable economic life, its cost is "amortized" over that useful life (amortization is the term to describe the allocation of the cost of an intangible -- just as depreciation describes the allocation of the cost of PP&E). Some intangibles have an indefinite life and those items are not amortized; instead, they are periodically evaluated for impairment. If they are never found to be impaired, they will permanently remain on the balance sheet. The unamortized/unimpaired cost of intangible assets is positioned in a separate balance sheet section immediately following Property, Plant, and Equipment.

20.1 An Amortization Example

Assume that Mercury Pharmaceutical purchased a patent for $50,000, estimating its useful life to be five years. The appropriate entries are:

1-1-X1	Patent		50,000	
	Cash			50,000
	Paid $50,000 to purchase a patent			
12-31-XX	Amortization Expense		10,000	
	Patent			10,000
	To record annual amortization expense ($50,000/5 years)			

Unlike PP&E, notice that the above annual amortization entry credits the asset account directly; there is no separate accumulated amortization account for intangible assets.

20.2 An Impairment Example

Assume that Music Download Service, Inc., purchased the internet domain name "notesthatfloats.com" for $50,000, estimating it to have an indefinite life. The Domain Name would be recorded at its initial cost, and not be subjected to annual amortization. However, should a periodic review (conducted at least once each year) reveal that the fair value of the asset is no longer at least $50,000, it will be necessary to record a loss and reduce the asset.

1-1-X1	Domain Name		50,000	
	Cash			50,000
	Paid $50,000 to purchase a domain name			
9-30-X3	Loss		25,000	
	Domain Name			25,000
	Internet "bust" caused the fair value of purchased domain name to be reduced by half			

20.3 Some Specific Intangibles

Patents give their owners exclusive rights to use or manufacture a particular product. The cost of a patent should be amortized over its useful life (not to exceed its legal life of 20 years). Importantly, the cost of a patent does not include the research and development costs incurred in seeking the knowledge necessary for the patent. The amount included in the Patent account includes only the cost of a purchased patent and/or incidental costs related to the registration of a patent (like legal fees).

Copyrights provide their owners with the exclusive right to produce or sell an artistic or published work. A copyright has a legal life equal to the life of the creator plus 70 years; the economic life is usually shorter. The economic life is the period of time over which the cost of a copyright should be amortized.

Franchises give their owners the right to manufacture or sell certain products or perform certain services on an exclusive or semi-exclusive basis. The cost of a franchise is reported as an intangible asset, and should be amortized over the estimated useful life.

Trademarks/brands/internet domains are another important class of intangible assets. Although these items have fairly short legal lives, they can be renewed over and over. As such, they have an indefinite life.

Goodwill is a unique intangible asset. Remember from Part 5.3, that goodwill is the excess of the purchase price paid for another company over the fair value of the net identifiable assets acquired. Such excess may be paid because of the acquired company's outstanding management, earnings record, or other similar features. Goodwill is deemed to have an indefinite life.