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Analysis on accounting for Intangible Assets and Depreciation in India

Abstract

Purpose: India has emerged at the top of the pedestal in the present knowledge-driven global marketplace, where intangible assets hold much more value than physical assets. The objective of this study is to determine the extent of intangible asset disclosure by companies in India

Methodology & Findings: This article highlights the concept of intangible assets, accounting treatment and provisions related with depreciation, various legal cases related with depreciation on intangible assets and other tax benefits for the promotion of research and development activities which will enhance intangible assets within the organisation.

This study relates to the years 2003-04 and 2007-08. Infosys technologies Ltd. is the company with the highest intangible assets reporting for both the years (2003-04: 68.52%, 2007-08: 81.48%).

Keywords: Intangible assets, Depreciation, Provisions, Research & Development Expenditure, Know-how, patents, Copy Right, non-monetary asset etc.

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Objective:

Objective of this article is to highlight and emphasized the importance of intangible assets in any organization and its accounting. How it create value for an organization on acquisition of any other enterprise or on expending of Research and Development activities.

Introduction

In the modern edge of knowledge era, it is very well accepted that intangible assets are the key drivers of the organisation. Intangible assets hold much more value than tangible 'visible' assets, it create value beyond tangible assets. Typically, book values determine the value of hard assets of a particular business while the process of valuation of intangible assets would help determine other value creators such as the potential, and the ability to earn. Significantly, the computation of the true value of a company requires a comprehensive assessment of both tangible and intangible assets. An intangible asset is a claim to future benefits that does not have a physical (e.g. building or equipment) or financial (e.g. stock or bond) embodiment[1].

According to nature and legality, intangible assets are categorised in two ways. The first group of intangibles represents the property without physical presence which is subject to special legal protection such as transferable and non-transferable copyrights, patents, models, trademarks, know-how, etc. Goodwill represents the second group of intangible assets. This category is particularly relevant for the tax and accounting area if arising on acquisition. It is described as any excess of the cost of the acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction.

Intangible Assets & AS-26 :

Definition: “an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.”[2]

Basis of recognition: As per AS-26, intangible assets should be recognized only if, (a) it is probable that the future economic benefits that re-attributable to the assets will flow to the enterprise, and (b) The cost of the assets can be measured reliably.

Accounting Treatment:

The valuation of intangibles is a complex issue although the main principles are the same as for tangible assets. The intangible asset is measured initially at cost in accounting, as for tangible assets. Besides that the accounting standards stress the importance of fair value accounting for intangible property. After the initial recognition the intangibles can be carried either at its cost less any accumulated amortisation and any accumulated impairment losses (cost model), or at a revalued amount being its fair value at the date of the revaluation less any subsequent accumulated amortisation and impairment losses (revaluation model).

Intangible assets are recorded at the consideration paid for the acquisition of such assets and are carried at cost less accumulated amortization and impairment. Goodwill comprises the excess of purchase consideration over the fair value of the net assets of the acquired enterprise. Goodwill arising on consolidation or acquisition is not amortised but is tested for impairment[3].

Intangible Assets and Deprecation:

Depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life[4.] Depreciation is one kind of notional loss, which arises due to physical wear and tear of the assets during production and manufacturing process. Deprecation allowance is provided for the replacement of assets after expiry of life and other side it is one of the tax shields, which will minimize the tax liability of the individuals or corporate assessee.

Finance (No.2) Act, 1998, for the first time, provided for allowance of depreciation on 'intangible assets' under the Income-tax Act, 1961. Section 32(1)(ii) of the Act provides that any know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, acquired by an assessee on or after 1.4.1998 are eligible for deprecation.

At present applicable rate of depreciation on intangible assets is @ 25 per cent. Now the question arises that their amortized value depends upon their performance and market demand or cost of acquisition less deprecation.

Goodwill as Intangible Assets and Depreciation:

Goodwill is an intangible asset, probably the most intangible of all intangible assets, hard to measure and even more difficult to account for. Goodwill today constitutes a much larger part of acquisition prices than it did previously, resulting in a much greater impact on financial statements. Goodwill is also a main part of intangible assets, but due to lack of clarity in the Income tax act and in accounting standards in many cases depreciation was not allowed by the taxation authorities on goodwill as intangible assets.

An opinion has been given by the Calcutta High Court in *Bird and Co. (108 ITR 253)* wherein the court observed that depreciation in the value of goodwill had to be taken into account either as business expenditure or purely as a capital loss. It is now well accepted that the amounts capitalised as goodwill, etc. have to be amortized in the books of accounts over a period, to know the true and fair profits. In this regard another judgment is also important in the case of *CIT v. Alps Theatre (65 ITR 377),* one may demand for the amortisation/depreciation on amounts paid as goodwill, etc. is not only a legal but a necessary charge for arriving at the assessable profits.

Furthermore on a careful reading of the Supreme Court's decision and the law under the Direct Taxes Code (DTC), (15th Schedule) it definitely suggests, on the basis of golden interpretation rule that – Depreciation is allowable on Goodwill under the DTC also although the same is not clearly and specifically mentioned in the DTC.

The Supreme Court in the case of *Khushal Shah v. Khorshed Boatwalla (AIR1970SC1147)* has held that goodwill of a business is an intangible asset being the whole advantage of the reputation and connections formed with the customers together with the circumstances that make the connection durable. Further, the Madras High Court in ***Rathnam's case*** *(71 ITR 433)* has referred to Lawson's Law of property, which observes that goodwill is the right to enjoy all the advantages of an established trade connection[5].

Intangible Assets and Other Tax Benefits:

Under Income-tax Act, 1961, apart from deprecation on intangible assets many other incentives are given to assessee for the research and development activities, through which they are generating intangible assets/ intellectual capital. An innovative industry in India can gain competitive advantage in the market if it develops the necessary expertise and skills in developing and manufacturing new products, which are patented. The following incentives would be extremely useful in promoting the culture of innovation and intellectual property protection in industries, academic and R&D institutions:

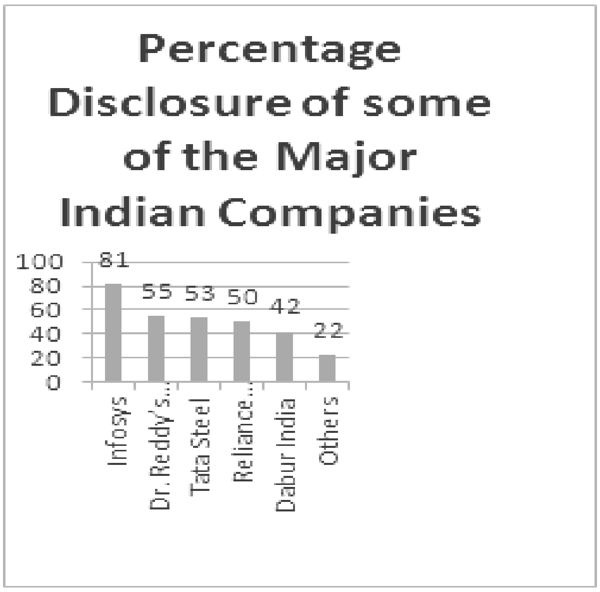
1. Weighted tax deduction on R&D expenditure
2. Accelerated depreciation allowance
3. Tax holiday to R&D companies
4. Income tax relief on R&D expenditure
5. Tax deduction for sponsoring research

Intangible Assets and Indian Companies:

Now-a-days there are many reasons for disclosing information by the companies related with intangible assets. It contributes to reducing the information irregularity between management, shareholders and investors. Several fast growing Indian companies, particularly in information technology sector, are fully dependent upon the intangible assets rather than tangible assets.

Study done during the year of 2007-2008 shows some of the major Indian companies and their percentage disclosure of the IA so developed[6].

Company Name	% Disclosure Of These Company (2007-08)
Infosys	81
Dr. Reddy's Laboratories	55
Tata Steel	53
Reliance Industries	50
Dabur India	42
Others	22



Conclusion:

Now-a-days intangible assets are very important in knowledge-based companies. As contribution of service-oriented industry increase in our economy (52.8% of GDP), intangible assets are having a greater importance in earning as well as wealth creation for the shareholders. The most valuable intangible assets for HUL are its brand and channel partners (both form the external structure). The market value of Dr. Reddy's is a factor of the quality of their knowledge base, the investment in R&D, the quality of their leadership (internal structure and employees' knowledge).

There is a need to develop an index of Intangible Assets disclosure to incorporate both quantitative as well as qualitative description of Intangible Assets. It is one of the most important system for driving company value & competitiveness. However very few corporations are aware of the potential of their intellectual assets and even fewer companies have strategies for extracting maximum value from their intellectual assets.

There are many more effective intangible assets which cannot be recognised by the firm in the current definition and practice due to unstable nature and continuous changes in their structure. To avoid court cases and unnecessary legal proceedings, CBDT has to take initiative to clarify and re-structure all the intangible assets from the depreciation and taxation point of view.

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4. AS-26, Para- 63
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