



Intangible Assets

- According to German GAAP

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Abstract

With the growth of global markets, intangible assets have become more and more important for both investors and managers in recent years. Although the economic importance of intangible assets has long been recognised, there has been extensive debate as to the definition of intangible assets, how to measure intangible assets, and the extent to which enterprises should be required to report these assets. Intangible Assets are likely to become increasingly important with the continuing development of high-technology industries and global service markets. The meaningful and comparable accounting for intangible assets is likely to remain one of the key international challenges facing the accounting profession during the next decade and beyond.

Keywords: Intangible Assets, Accounting

1. Introduction

Intangible assets have grown in importance for both investors and managers in recent years. With the growth of global markets, the service sector, and the level of mergers and acquisitions, such intangible assets as brands, trademarks, patents and goodwill have become increasingly significant. Companies today create value to a large degree through business processes and activities that are based on knowledge assets, on productive relationships with customers and other business partners, on their public reputation and on the recognition of their brands and products in the global market place, and in particular on their innovative power and on new technologies. It is common for the most valuable resources of a company, for example, its market image or reputation, a technological advantage to be protected by a patent.

Although the economic importance of intangible assets has long been recognised, there has been extensive debate as to the definition of intangible assets, how to measure intangible assets, and the extent to which enterprises should be required to report these assets due to the special characteristics of intangible assets, namely the high levels of investment risk and uncertainty. The growing gap between the market value of a company and between what it reports in its financial statements demonstrates that the real value drivers are no longer captured through traditional management and accounting instruments such as the balance sheet and the income statement. Managers can no longer run a company successfully, and investors cannot make judgments about a possible investment, based on this information alone.

2. Definition and Classification of Intangible Assets

The accounting for intangible assets must be considered in the context of the objectives of financial statements as a whole; certainly one such objective is to provide users of financial statements with useful and reliable information to facilitate their decision-making processes. To achieve this objective, the information must be relevant, understandable, and reliable. (D.R, Carmichael, 1996, P. 365)

2.1 Purpose of Accounting in Germany

In the past German industry was dominated by the “Mittelstand” – private companies (many of which are effectively family businesses), whose capital has traditionally been provided by the banking sector. Consequently, the major developments in German accounting have been driven by the needs of the creditors (the so called “Gläubigerschutzprinzip”) rather than those of the shareholders. Although it is possible to argue that profitability is most important to the general user of US financial statements, financial security (balance sheet) has traditionally been more important to the German user. From the beginning, German accounting was regarded as a matter of law. The predominant purpose of accounting was to show the wealth of an entity, primarily to enable creditors to evaluate their risks.

Up to date, as a result of increased cross-border capital flows and the orientation of many enterprises towards the requirements of international capital markets, consolidated financial statements are gradually becoming the focus of public interest. Aiming at making the capital markets more competitive, the German legislation supports this development by allowing that, listed companies may alternatively fully apply IAS or US GAAP in place of German rules in their consolidated financial statements, so long as these comply with EU Directives.

2.2 Accounting Standard Setting in Germany

The HGB is the American version of the GAAP (Generally Accepted Accounting Principles) in Germany. It has been regulating the accounting system since 1897. HGB was amended in 1985 in order to follow the European Harmonization process in financial accounting. It not often amended because, unlike the US, Germany is under code law. Because code law is not based on interpretation, accounting standards are very detailed. However, German accounting leans toward the professional end of the scale rather than the statutory. (Clare Roberts, Pauline Weetman and Paul Gordan, 2002, P. 310)

It is important to distinguish between the "Handelsgesetzbuch" (HGB—the German Commercial Code), and the "Grundsätze ordnungsmäßiger Buchführung" (GoB—German Principles of Proper Accounting). It is rather misleading to refer to the GoB as "German GAAP" certainly in formal contexts such as financial statements, because although they are the nearest thing Germany has to GAAP, they are neither defined as such, nor do they fulfil the same purpose. Accountants, however, frequently refer to the GoB as "German GAAP."

Financial statements of all business entities in Germany are required to be drawn up in accordance with GAAP (GoB or HGB). Traditionally, German accounting practice is a result of detailed codification. The main accounting rules are governed by the Commercial Code (HGB). Special regulations applicable to specific legal forms are included in the Stock Corporation Law dealing with public companies and the law on Limited Liability Companies. All other large entities must comply with the regulations under the Publicity Law.

In 1998, the German Accounting Standards Committee (GASC, "Deutsches Rechnungslegungsstandards Committee" or DRSC) was set up by the government. This body was a non-governmental organization and it was given the following tasks:

development of accounting standards for listed companies' consolidated financial statements

advising the German Ministry of Justice on changes in accounting standards

liaison with international standard setters and representation at international accounting committees.

Since then, they have formed 17 standards. On November 14, 2001 GASC has implemented a draft on Intangible Assets: "Entwurf, Deutscher Rechnungslegungs Standard Nr. 14". (DRSC) But it is not clear, whether it is already accepted or not, due to the debate.

2.3 Definition of Intangible Assets

Effectively, in Germany, intangible assets, like tangible assets, are not legally defined. The general definition of an asset which has developed in German accounting tradition as "principle of proper accounting" (Grundsätze ordnungsmäßiger Buchführung, GoB) does apply to tangibles as well as intangibles. In Germany, the definition of intangible assets is "fixed assets other than tangible or financial", so called "conceptual approaches by opposition". (Hervé Stolowy & Anne Jeny, 1999, P. 6) Thus as intangible assets are regarded all items which apply to the general asset definition and which are fixed but not tangible (so without physical substance) or financial. (Haller, 1998, P. 564)

In comparison, we may quote the IASC's definition: an intangible asset is "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. An asset is a resource controlled by an enterprise as a result of past events; and from which future economic benefits are expected to flow to the enterprise". (IAS 38 "Intangible Assets") The major formal difference to the IASC definition is that the German definition does not explicitly stress the characteristic of a "future economic benefit". It speaks about an "economic value" which an item incorporates, which mostly but not necessarily implicitly incorporates the idea of a future economic benefit. The predominant two components of the German asset definition are, quite comparable to the IASC approach, that an asset must be identifiable (which means that it can be separated from the business) and independently as well as reliably measurable. Thus in respect of separability of the item from the enterprise and its independent measurability the definition of intangible assets in Germany is quite comparable to that of the IASC. Nevertheless the German definitions of intangible assets are not in contradiction with the IASC definition but are less specific.

2.4 Classification of Intangible Assets

According to § 266 (2) HGB there are three main kinds of intangible assets as following:

Concessions, industrial and similar rights and assets and licenses in such rights and assets

Goodwill

Payments on account (See Chart 1)

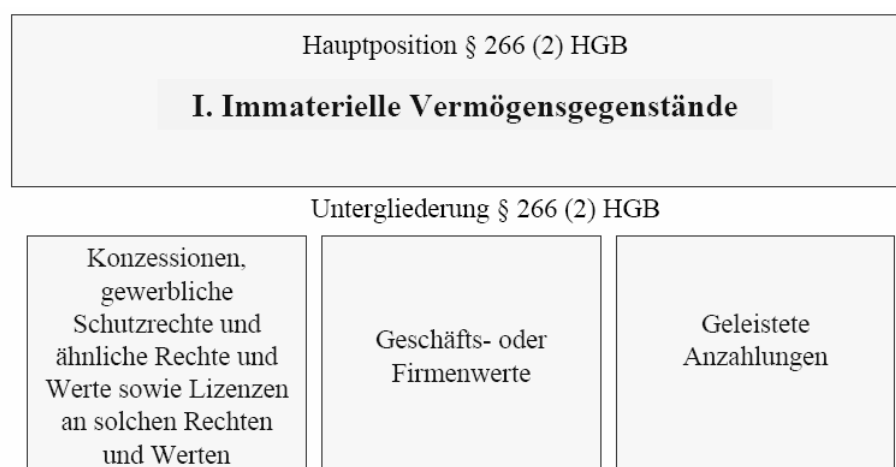


Table 1. Many important specific types of intangible assets

Intangible Assets Category	Example
Marketing	Brand names, logos and trademarks
Technological Process	patents, technical documentation and patent applications
Artistic	Copyrights, musical composition and maps
Data processing	Proprietary software, software copyrights, automated databases
Engineering	Industrial design, patents, blueprints, trade secrets, engineering drawings
Customer	Customer lists, contracts, customer loyalty, open purchase orders
Contracts	Favourable supplier contracts, licenses, franchises held, non competition agreements
Human capital	Trained and assembled workforce, employment contracts/agreements
Location	Leasehold interests, mineral exploitation rights, air rights, water rights, easy access, special views
Goodwill	Institutional goodwill, personal goodwill of a professional, general business going-concern value

(Source: "Valuing intangible assets" March 2003) (RICS Plant and Machinery Faculty)

3. Accounting for Goodwill

3.1 Definition of Goodwill

According to § 255 (4) HGB Goodwill is calculated as the difference between the cost of the acquisition and the value of the individual assets of the company acquired less the liabilities at the time of the acquisition. In Germany, if the acquisition cost is higher than the proportional net asset value of the acquired subsidiary, the difference on first consolidation must be allocated to the various asset accounts or be compensated with certain liability accounts of the acquired company (HGB, Para. 301 al. 1, s. 3). The part of the consolidation difference which cannot be allocated to

specific assets, has to be treated as goodwill (“Geschäfts- und Firmenwert”, HGB, Para. 268 al. 2) which is disclosed under the balance sheet heading of intangible assets.

Goodwill may either be positive or negative. Positive goodwill represents benefits attributable to a business which are derived from the combination of the assets of a business rather than from any identifiable asset. Examples include a favourable reputation, customer loyalty, the skills of management, or the workforce. Negative goodwill may result from a bargain purchase or where disadvantages exist, such as poor market perception or on unmotivated workforce.

3.2 Accounting Principles for Goodwill According to HGB and GAS

3.2.1 Treatment

The general prohibition to recognize self generated assets applies accordingly to self-produced goodwill (HGB § 255, Para. 4). Accounting for acquired goodwill is regulated by a system of individual rules whereas according to IAS or US GAAP, goodwill accounting rules follow the economic content of the transaction. Therewith, the commercial code does not underlie a continuous conception. (Ordelheide, 1997, p.574).

According to HGB § 255 Para. 4, goodwill originated from an asset deal may be taken up into the balance sheet. It represents the difference between the consideration paid on the acquisition of an enterprise and the current value of the individual assets less its liabilities at the date of acquisition. This rule enables preparers to invest significant amounts in goodwill without rendering an account. (Ordelheide, 1997, p.579).

If the goodwill is capitalized it must be either amortized in each succeeding year by at least 25 percent or be distributed systematically over the years that are likely to benefit (HGB § 255, Para. 4). If not recognized, the corresponding amount must be expensed. It is not allowed to charge goodwill directly against reserves. Although HGB § 255 Para. 4 keeps silent on conditions for exceptional depreciation, it is accepted that for permanent decrease in value the goodwill should be written down to the lower attributable value and can or should be written back if the reason for the write-down has ceased to exist.

Goodwill accounting in connection with the consolidation of capital varies in certain aspects from the individual accounting rules. According to HGB § 301 Para. 1 and 3, the difference between the consolidation difference and the allocated current and book value differences must be capitalized as goodwill. HGB § 309 Para. 1 offers the following options for the treatment of goodwill in group accounts:

Amortization over the four years following the first consolidation at a rate of at least a quarter each year;

Amortization over its economic life without definition of a maximum period;

Set-off against the group’s reserves.

Additionally, in practice combinations of these options and also a proportional set-off against reserves can be observed.

GAS 4 “Purchasing Accounting” (August 2000) in Consolidated Financial Statements limits these options and also fills some of the loopholes, effective since the financial year 2001. (GAS 4-62) Goodwill arising on the consolidation should be recognized as an asset and should be amortized over its expected life. As a general rule, the goodwill should be amortized using the straight-line method and the amortization period can exceed 20 years in justified cases only. The recoverability of goodwill and the remaining useful life should be reviewed annually. Unscheduled amortization should be recognized in the case of impairment. (AS 4-27 and 4-31)

3.2.2 Negative Goodwill

The standard also sets out rules for accounting for negative goodwill. Requirements for the presentation of negative goodwill exist for the group accounts only (§ 309 (2) HGB). In individual company’s accounts a corresponding accrual (provision) can be set up. Negative goodwill should be shown separately in the balance sheet, “Unterschiedsbetrag aus der Kapitalkonsolidierung”, within the equity section on the liabilities side of the balance sheet (§ 301 (3) 2 HGB). It should be released to income when future expenses or losses relating to the acquisition are incurred. If there is no connection to future expenses or losses, the amount by which the negative goodwill is lower than the fair values of the non-monetary assets acquired should be recognized on a systematic basis over the weighted average of the remaining useful life of the depreciable assets. The remaining difference should be recognized as income immediately at first consolidation. (GAS 4-38-41) Overall, GAS 4 is intensely influenced by IAS 22.

3.2.3 Impairment Reviews

German GAAP does not have a notion of impairment reviews. However, exceptional amortisation should be provided for a permanent diminution in value. (§ 253 (2) 3 HGB)

When the circumstances that caused a permanent diminution in value to be recognised change, reversal of the original write down must also be recognised in the profit and loss account. (§ 280 HGB)

3.2.4 Accounting Comparison for Goodwill

Table 2. Accounting for Goodwill for Selected Major Industrialized Countries

Accounting for Goodwill for Selected Major Industrialized Countries						
	IASC	U.S.	EC	U.K.		Ger.
Technical References	St. No.22	APB No. 16, 17	7 th Dir. A. 19 30, 31	FRED No. 12	ED 47	CC
Positive purchased goodwill						
Recognized as an asset and amortized	M	M	A	A	M	A
Written off against shareholders' equity	U	U	A	U	U	A
Maximum number of years for amortization						
Without specific justification	5	40	5	20	20	4 or less
With specific justification	20	40	NS	NS	40	5 or more
Negative purchased goodwill						
Allocated over non-monetary assets;						
Remaining part treated as deterred income and amortized	P	M(1)	U	U	U	U
Treated as deferred income and amortized	AI	U	A	M	M	U
Taken to shareholders' equity	U	U	NS	U	U	M(2)
Capitalization of non purchased Goodwill, permitted?	NS	U	U	U	U	U
Status of the methods of a accounting treatment:						
M: Mandatory method or treatment.						
P: Preferred method or treatment, or "benchmark" in the IASC terminology						
A: Allowed method or treatment.						
AI: Allowed method or treatment, with additional information in the notes to financial statements.						
U: Unauthorized method or treatment.						
NS: Not specified.						
Technical Abbreviations:						
IASC	St:	Statement				
U.S.	APB:	Accounting Principles Board				
EC	Dir.:	EEC Directive				
	A :	Article				
U.K.		Statements of Standard Accounting Practice				
	FRED: (3)	Financial Reporting Exposure Draft				
Ger.	CC:	Commercial Code				

Notes :

- (1). U.S.: Negative goodwill is first allocated to reduce proportionately the value assigned to concurrent assets (except long-term investments in marketable securities and any other long-term assets expected to be liquidated in the near term).
- (2). Ger.: Negative goodwill must be shown separately as equity or between equity and liabilities, depending on the nature of the negative goodwill. It may only be released to income if the enterprise incurs a loss, which was foreseen at the time of acquiring the shares or when considered for the first time, or, it becomes clear on the balance sheet data that it corresponds to a realized profit.
- (3). U.K.: FRED 12 was exposed for comment in June of 1996; it would reduce the current range of accounting choices.

(Source: "International Accounting and Finance Handbook", Chapter 14, "Intangibles")

The following table sets out a survey of practices in accounting for goodwill in some countries. In summary, the systematic amortization of goodwill over its useful life, subject to a maximum period, is the prevalent practice, being mandatory in the United States, Canada, Japan, and Austria. In the EU countries, allowed treatments have been narrowed in either systematic amortization or immediate write-off to reserves, especially in Germany and France. (Frederick D.S. Chol, P. 14 -8)

4. Accounting for Concessions, Brands, Patents and Similar Intangible Assets

"concessions and similar rights, patents, licenses, brands, processes, rights and similar assets" are not explicitly mentioned in the correspondent balance sheet position according to German rules (Para. 266 (2) HGB Handelsgesetzbuch – Commercial Code), but they are covered as they belong to the term "gewerbliche Schutzrechte", which are mentioned in the rule.

There are acquired identifiable intangible assets and internally generated identifiable intangible assets. Acquired identifiable intangible assets refer to the purchase of patents, trademarks, licenses, or customer lists etc. Internally generated identifiable intangible assets include legal fees, registration costs, and other expenditures directly related to securing rights such as patents or copyrights.

4.1 Accounting Practices in Germany

According to HGB § 248 (2) an internally generated intangible asset (e.g. software, brands etc.) cannot be capitalised. Both internally developed and purchased software are capitalized and amortized over their estimated useful life.

Intangibles are required to be amortised over their useful economic lives. In Germany, recognized intangible assets - with exception of the acquired goodwill - have to be amortized over the useful life. The company is free in the choice of amortization method between straight-line or declining balance. There has been considerable debate over the accounting treatment of brands. In Germany almost recently rose a discussion whether a brand has a determined useful life and if, which period is adequate for financial accounting purposes. In 1996 the federal court for tax affairs ("Bundesfinanzhof" - BFH) decided that there is no reliable estimation for a specific limitation of the useful life and the amortization of brands. Therefore brands should not be subject to an amortization. As a reaction, the ministry of finance in opposition declared in 1998, that it generally supposes a useful life for brands of 15 years (same as for goodwill) if the owner can not proof a shorter period. As in Germany accounting for tax purposes and the financial accounting are closely connected through the so-called "Maßgeblichkeitsprinzip", (Haller, A., 1992, P.310-323) these statements gain relevance for financial accounting, too.

German GAAP does not allow revaluation of assets in excess of original cost as reduced by depreciation. It is absolutely clear in Germany and France that in accordance with the Fourth European Directive (Article 33, Para. 1), the revaluation of intangible assets is generally not allowed. In Germany, because - due to the strong principle of prudence - revaluation is not accepted for any asset,

4.2 Accounting Comparison for Brands, Patents and Similar Intangible Assets

The following table sets out a survey of national accounting practices for brands, patents, trademarks, and similar intangible assets in U.S., U.K., and Germany in comparison to IASC. In many countries, the accounting for intangible assets other than goodwill had not been addressed or proscribed in detail, especially in Germany.

Table 3. Accounting for Brands, Patents, Trademarks, and Similar Intangibles for Selected Major Industrialized Countries

Accounting for Brands, Patents, Trademarks, and Similar Intangibles for Selected Major Industrialized Countries					
Technical References	IASC	U.S.	EC	U.K.	Ger.
	IAS No.22	APB No.17	4 th Dir. A. 33(1)	FRED No. 12	
Accounting for Purchased Identifiable Intangibles					
Recognized as an asset	M	M	A	A(2)	M
Systematically amortized	U	U	A	M(3)	M
Maximum number of years for amortization					
Without specific justification	NS	40	UEL	20	UEL
With specific justification	NS	40	NS	NS	NS
Is Capitalization permitted for:					
Internally developed Identifiable intangibles?	NS	A(4)	A	U	U
Internally developed brands?	NS	U	(1)	U	U
Status of the methods of a accounting treatment: UEL: Useful Economic Life					
Notes :					
(1) EC: Under the alternative valuation rules of the EEC 4 th Directive, “current cost” valuation for intangibles is permitted. This alternative has been reflected in company law by most member states, including the United Kingdom.					
(2) U.K.: Under FRED 12 (an exposure draft) an intangible asset should only be capitalized if it can be disposed of separately and there is a reliable method of measuring its fair value at acquisition.					
(3) U.K.: FRED 12 would establish a rebuttable presumption of a finite life for all intangibles.					
(4) U.S.: Internally developed intangible assets which are not specifically identifiable or have indeterminate lives are generally deducted from income when incurred.					

(Source: “International Accounting and Finance Handbook”, Chapter 14, “Intangibles”)

5. Accounting for Payments on Account

According to HGB § 266 Abs. 2, payments on account refer to the related costs on the acquisition of the intangible assets. An intangible asset purchased from a third party is recorded at cost. Examples include research and development expenditure, start-up costs, and etc.

5.1 Accounting Principles for Payments on Account in Germany

Generally, own research and development expenditure is required to be expensed as incurred. (§ 248 (2) HGB) This is due primarily to the level of uncertainty and remoteness of future economic benefit. Internally generated intangible assets, including development costs, cannot be capitalised.

Expenses incurred to start up or expand a business, to the extent they are not capitalised as part of other assets, may be carried forward as an accounting convenience. This item is required to be presented on the face of the balance sheet above fixed assets under the heading “Start-up and Business Expansion Expenses” and must be explained in the notes.

Start-up expenses within the meaning of § 269 HGB are defined as all expenses which are incurred during the start-up phase of a business including the initial establishment of the internal and external organisation and the preparation of the business for the start of the regular production of goods and services. Examples include preliminary market studies and other planning costs, recruitment and training of staff, test runs of production facilities as well as depreciation, rent and rentals, interest and other personnel expenses incurred during the start up phase. Even if such expenditure is capitalised it is deducted from profits available for distribution. (§ 269 HGB)

Amounts recorded in respect of start up and business expansion expenses must be amortised in each following financial year by at least one quarter. (§ 282 HGB)

Capitalisation of start-up and expansion costs is not permitted for tax purposes, and therefore it results in recognition of a deferred tax liability. (§ 274 HGB)

6. Conclusion

The nature of intangible assets, particularly the fact that they are often internally generated and therefore give rise to difficult identification and measurement problems, makes the accounting for these assets complex and sometimes subjective. It is an area of divergent practices, particularly on an international level, and also of considerable debate and disagreement standards around the world continues to change as standard-setters continue to modify the accounting rules. Intangible Assets are likely to become increasingly important with the continuing development of high-technology industries and global service markets. The meaningful and comparable accounting for intangible assets is likely to remain one of the key international challenges facing the accounting profession during the next decade and beyond.

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