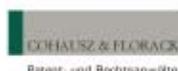


Intellectual Asset **Management**

## International Report

### Intangible assets and the Accounting Modernisation Act

[Cohausz & Florack](#) - Germany



[Erik GW Schäfer](#)

Nazim Söylemezoglu

21 Jan 2009

The German legislature is considering the biggest revision of the accounting rules in the Commercial Code since 1985 - the Accounting Modernisation Act. Although it does not completely do away with the conservative approach to accounting contained in the existing Commercial Code, it is likely to modernise it in some key ways. This article addresses changes that will affect German companies engaged in research and development (R&D).

The draft Accounting Modernisation Act is intended to improve the informative value and transparency of balance sheets and to begin a gradual shift towards the accounting standards set out by the International Financial Reporting Standards. In general, the act largely does away with optional rules, instead introducing more mandatory accounting rules.

Notably, the act will modify the provisions dealing with “self-produced” intangible assets. “Intangible assets” are identifiable assets that have neither a physical existence nor an intrinsic monetary value (see International Accounting Standard 38, International Financial Reporting Standard 5). They include intellectual property such as patents, trademarks and copyrights, but may also comprise customer lists, trade secrets and management concepts. In contrast, goodwill is not an intangible asset in the sense of the law because it arises from the combination of all constituent parts of a company and may not be identified and separated from other parts. At present, a company developing its own intangible asset (eg, a new manufacturing technology) can obtain a patent, but neither the patent nor the technological knowledge can be included as an asset in the balance sheet because the asset is intangible and self-produced. However, a company buying the same technology and the same patent from another company can activate the intangible assets in its balance sheet with a value corresponding to the acquisition price because the asset is not self-produced and has a price tag. This could lead to the peculiar situation where the balance

sheets of two companies with fully comparable assets acquired or created at the same price are significantly different.

The act does away with this distinction to a certain degree. Although the legislature has not yet finalised all details of the act, it is clear that companies will have to include self-produced intangible assets on the balance sheet. The draft bill excludes trademarks, publishing rights, customer lists and similar intangible assets.

Does the inclusion of patents finally mean that small, research-oriented start-ups with lucrative patents of their own invention will now be able to “dwarf” companies of the old economy on the balance sheet even before going public? Not quite.

First, the value of self-produced intangible assets is not based on a fair price. Rather, it is capped on the balance sheet at the value of their respective production costs. In the case of patents, this essentially corresponds to the salaries of developers and the costs of their equipment. While this may add up to a substantial amount for larger companies with many patents, for a two-person start-up working in a garage it will inevitably turn out to be a lot less, even if the resulting patent earns royalties in the millions. Moreover, only development costs are considered production costs for intangible assets - research costs are not. This begs the question of how to distinguish one from the other. For the purposes of the act, research stops and development begins when it may be “assumed with a high probability that an intangible asset will be produced in the future”. Any production costs incurred beyond this point contribute to the value of the intangible asset on the balance sheet. In order to record the point of transition from research to development, companies will need work-flow processes for documenting R&D activities more extensively.

Second, under the act self-produced intangible assets become relevant for the balance sheet, but not for the income statement. Consequently there is no change for the purposes of taxation.

Third, a company reporting self-produced intangible assets on the balance sheets is required to keep retained earnings in the amount of the self-produced intangible assets. This is because self-produced intangible assets are considered to be an “uncertain asset increase”. Thus, any increase in profits is effectively exempt from disbursement. No dividend may be paid from the higher earnings due to the self-produced intangible assets that are activated on the balance sheet.

Fourth, intangible assets are also subject to depreciation. The regular depreciation period is not fixed but depends on the actual period during which the intangible asset exists and is expected to generate revenue. This may be quite different from one intangible asset to another, since IP rights have a different statutory duration. A loss of value of intangible assets may also require extraordinary value adjustments on the balance sheet. For

example, a patent may be invalidated, secret know-how may fall into the public domain or patented technology may become obsolete through advancement of technology.

Thus, the act does not embrace “fair value” accounting and, with its rather restrictive approach, falls short of bold accounting innovations that could have been implemented. Therefore, it is unclear how much of an impact it will have.

Since the inclusion of self-produced intangible assets on the balance sheet is likely to be a mandatory legal requirement, rather than an optional one, German companies will have to ensure compliance. For this purpose, extensive documentation of the process and costs leading up to the creation of the specific intangible asset will be necessary, which hitherto might be broadly included in a R&D budget. Therefore, every company involved in R&D in Germany should take note lest it be caught unawares. In particular, companies that engage heavily in the development of new technology (ie, intangible assets) may be able to increase their capital significantly. This may help to facilitate access to credit or capital. Those who might regret that the act does not embrace fair value accounting should bear in mind that the sometimes devastating adverse effect of necessary extraordinary value adjustments is likely to be smaller when using the envisaged valuation method based on historic costs.

In the current climate, lawmakers pondering accounting regulations have every reason to err on the side of caution and last-minute changes may be expected. This explains why the act will probably come into force only in 2010, and not in early 2009 as was expected. In any event, the act will constitute an improvement for IP owners that engage in R&D in comparison with the present situation.

**For further information please contact:**

Erik GW Schäfer

Cohausz & Florack

[www.cohausz-florack.de](http://www.cohausz-florack.de)

Email: [eschaefer@cohausz-florack.de](mailto:eschaefer@cohausz-florack.de)

Tel: +49 211 90 49 00

© Copyright 2003-2009 **Globe White Page Ltd**