DRAFT DISCUSSION PAPER: BETTER INFORMATION ON INTANGIBLES

WHICH IS THE BEST WAY TO GO?

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EFRAG
European Financial Reporting Advisory Group

INTRODUCTION

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Discussion Paper prepared as part of EFRAG's project *Better Information on Intangibles*

- Based on input from members of the EFRAG Advisory Panel on Intangibles.
- Presents **various alternatives** for providing better information on intangibles and discusses their benefits and disadvantages.
- No recommendations included on the selection of a particular approach.
- Addresses 'intangibles' with reference to **intangible sources of possible economic benefits** (including items that would not meet the IFRS definition of an asset).
- Only considers **information to be included in financial reports** (financial statements and management report).
- Approaches presented only deal with how to provide better information for **intangibles that are used in the entity's operations**.
- Scope also limited to cover only **information that is useful for the primary users of financial reporting**.

ISSUES WITH THE CURRENT INFORMATION 1/2

What was identified

- Value relevance of financial statements is decreasing possibly due to financial statements not reflecting information about intangibles:
  - **Intangibles are now more important for more entities** than previously.
  - **Information asymmetry affects company's market value** (inefficient capital allocation; assessment of the management's stewardship difficult).
- Difficult for users to compare **entities that grow organically** with **those growing by means of acquisition**:
  - IFRSs require acquired intangibles to be recognised, while **internally generated intangibles can only be recognised in specific circumstances**.

ISSUES WITH THE CURRENT INFORMATION 2/2

What was identified - ctd

- Issues with a scenario of recognising more internally generated intangibles:
  - **Measurement at cost and at fair value already problematic** for recognised intangible assets.
  - In addition, **not all intangibles would meet the definition of an asset**.
- Alternative scenario to require additional disclosures as the way forward:
  - **Boundaries between different intangibles** are not (well) defined and are interpreted differently.
  - There are **no generally accepted ways on how to report** on intangibles.
  - Additional information on intangibles **may be commercially sensitive** to provide.

APPROACHES CONSIDERED

How to provide better information on intangibles

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How to provide better information on intangibles

Chapter 3	Chapter 4	Chapter 5
• **Recognition and measurement** in the primary financial statements	• **Information relating to specific intangibles** in the notes to the financial statements or in the management report	• **Information on future-oriented expenses and risk/opportunity factors** that may affect future performance in the notes to the financial statements or in the management report

RECOGNITION AND MEASUREMENT IN THE PRIMARY FINANCIAL STATEMENTS 1/6

Issues with IFRS regarding intangibles

- Under IFRS similar intangible assets can being accounted for differently depending on whether they are **acquired** or **internally generated**.
  - Intangibles are **generally recognised only if acquired separately** (individual purchase or purchase of a group of assets) **or as part of a business combination**.
  - **Internally generated intangibles**, other than development costs, are **not generally recognised** as assets in the financial statements even though they may be the most important intangibles for entities.
  - Accordingly, both costs related to the income of the current period and costs related to gaining income in the future are recognised as **expenses in the statement of financial performance**.
- **Difficult to compare IFRS financial statements** of an entity with substantial internally generated intangibles, with those of another entity that has purchased most of its intangible assets.

RECOGNITION AND MEASUREMENT IN THE PRIMARY FINANCIAL STATEMENTS 2/6

Attempts to facilitate comparability between entities

- Necessary to facilitate **financial performance comparison** between entities growing by acquisition and those growing organically.
- **Alternative performance measures**:
  - Provided voluntarily by some entities adjusting the results for the components of the purchase price allocation.
  - But do not enhance the comparability of the statements of financial position.
- Consideration could also be given to **recognising less intangible assets separately from goodwill in a business combination**.
  - Such an approach was not widely supported in the recent IASB consultation on its discussion paper *Business Combinations - Disclosures, Goodwill and Impairment*.

RECOGNITION AND MEASUREMENT IN THE PRIMARY FINANCIAL STATEMENTS 3/6

Alternative recognition (and measurement) requirements to those currently applied

- Three questions to address in considering the **recognition and measurement of (internally generated) intangibles**:

  1. **Which type(s) of intangibles** should be considered for recognition (and measurement)?
  2. **Under which circumstances** should such intangibles be recognised?
  3. **Which measurement basis or bases** should be considered?

- The proposed approaches under this section focus on **intangibles that meet the definition of an asset under the IFRS Conceptual Framework**.

RECOGNITION AND MEASUREMENT IN THE PRIMARY FINANCIAL STATEMENTS 4/6

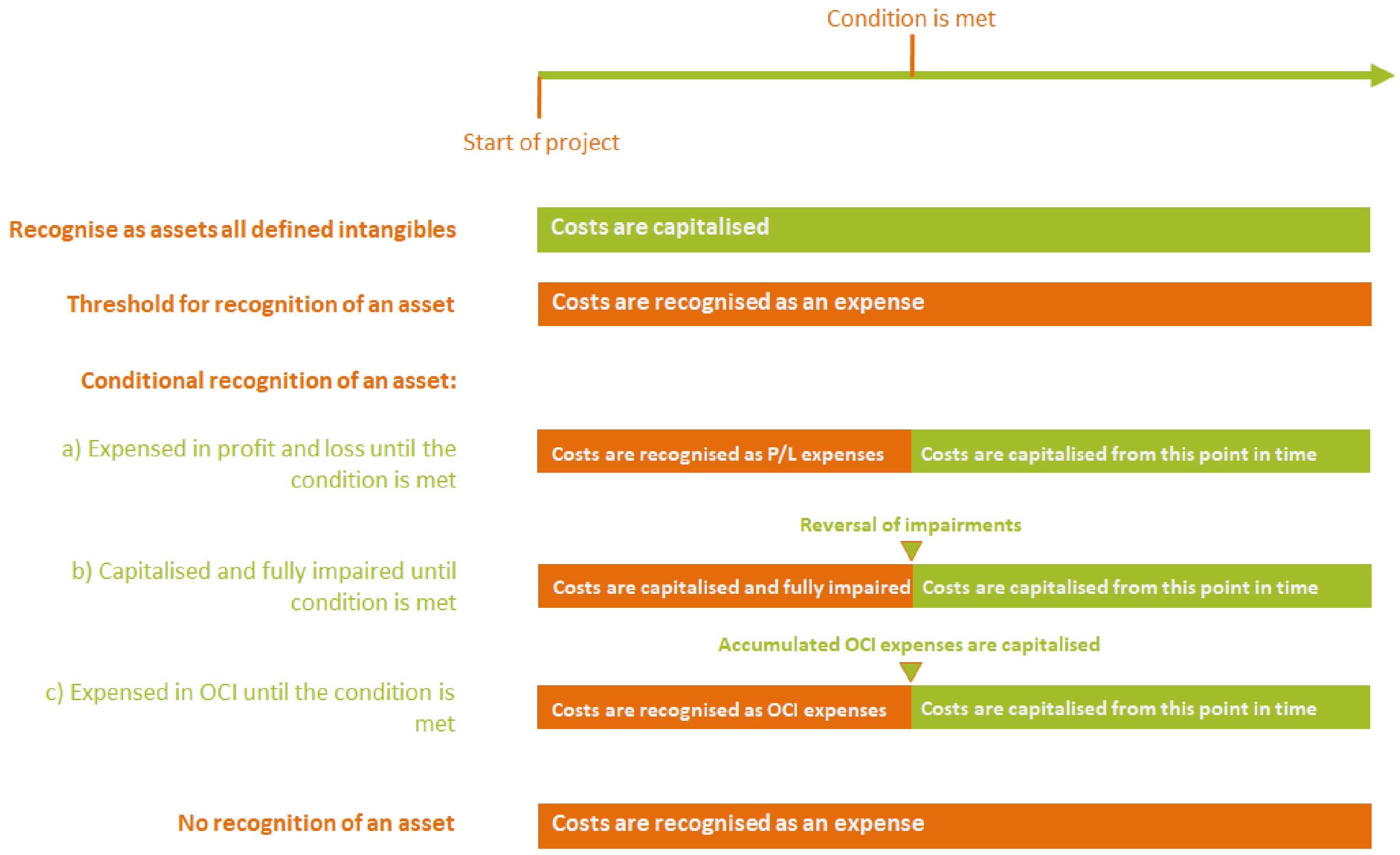
Approaches presented

- **Four different approaches** to recognition of intangible assets*:
  1. **All intangible assets are generally recognised**.
  2. **Intangible assets are recognised *if* certain criteria are met** (threshold for recognition).
  3. **Intangible assets are recognised when they meet certain criteria** (conditional recognition – different alternatives).
  4. **No internally generated intangible assets are recognised**.
- **Advantages and disadvantages** of the various approaches are identified in the Discussion paper.

*: Distinction suggested in a study by Barker et al.

RECOGNITION AND MEASUREMENT IN THE PRIMARY FINANCIAL STATEMENTS 5/6

Approaches illustrated



RECOGNITION AND MEASUREMENT IN THE PRIMARY FINANCIAL STATEMENTS 6/6

Measurement

- Focus of the discussion is on **measurement at cost and fair value** without expressing a preference for any of them.
- Both cost and at fair value may be problematic:
  - For fair value measurement, an issue is that there is no active market for most intangibles.
  - For measurement at cost, the issue is that it can be difficulty to identify / allocate internal cost.
- Factors to consider include:
  - Whether an asset produces cash flows directly and could be sold independently.
  - Whether the entity's business activities involve the use of several economic resources (including intangibles) that produce cash flows indirectly by being used in combination.
- DP includes arguments for an against measurement at cost and fair value, respectively.

INFORMATION RELATING TO SPECIFIC INTANGIBLES 1/2

Disclosure of information on specific intangibles

- Are the benefits of recognising more internally generated intangibles certain and would they outweigh the associated costs?
- Alternative proposed:
  - Provide better **disclosures on specific intangibles** to**:**
    - ✓ Help users of financial reports assess the **contribution of those intangibles to the value of / value creation by the entity**.
    - ✓ **Supplement the recognition of some internally generated intangibles**.
- Specific intangibles:
  - Those that are **key to an entity in relation to its business model**.
- Information provided could be qualitative, quantitative, or both.

INFORMATION RELATING TO SPECIFIC INTANGIBLES 2/2

Advantages and disadvantages

- Advantages include:
    - Detailed information provided on intangibles that are key to an entity.
    - Possibly less subjective, as well as less complex (and hence less costly), compared to recognising and/or measuring intangibles.
- Disadvantages include:
    - May be difficult to determine the particular intangible the disclosures would relate to.
    - Not a solution to the issue of distorted IFRS performance measures resulting from not recognising internally generated intangibles.
    - Would not provide information on the value intangibles are creating together with other assets.

INFORMATION ON FUTURE-ORIENTED EXPENSES AND RISK/OPPORTUNITY FACTORS 1/4

Disclosure of information on recognised expenses that are expected to benefit future periods

- Not to assess the value of individual assets, but to assess the financial performance of a period and for predicting future financial performance would be useful.
- Currently, some recognised expenses (may) relate to income in future periods. One approach could be to capitalise the costs, but Chapter 3 identified issues with recognising all types of intangibles that could affect the performance of future periods.
- Distinction between recognised expenses relating to future period and recognised expenses relating to current (and past) periods, either by:
  - Providing the assessment of an entity's management on which recognised expenses relate to future earnings; or
  - Providing information to help users make their assessments of which recognised expenses relate to future periods.

INFORMATION ON FUTURE-ORIENTED EXPENSES AND RISK/OPPORTUNITY FACTORS 2/4

Possible approaches

- Split based on management's assessments
  - Advantage: Could be the most accurate information and additional information could be provided e.g., on expectations on when the benefits will flow to the entity.
  - Disadvantage: The split would be subjective and users may prefer to make their own split.
- Information to enable users make their own split
  - E.g. by providing more granular information on expenses recognised e.g., patent expenses, marketing expenses (including information on trademarks/brands and staff training).

INFORMATION ON FUTURE-ORIENTED EXPENSES AND RISK/OPPORTUNITY FACTORS 3/4

Advantages and disadvantages

- Advantages include:
  - No need for fixed terminology to be used to distinguish between different intangibles in order to provide information on the recognised expenses of a period.

    NB - A fixed terminology for types of expenses may be needed.
  - Approach based on the combined effect on earnings at entity level, hence caters for the fact that often intangibles do not create much value on a stand-alone basis but together with other intangibles and assets.
- Disadvantages include:
  - Information on the effectiveness of the investments is not reflected (IFRS performance figures will still be distorted).
  - Information will not be so useful for assessing management's stewardship (other than through disclosing how the entity is dealing with risks and opportunity factors).

INFORMATION ON FUTURE-ORIENTED EXPENSES AND RISK/OPPORTUNITY FACTORS 4/4

Risk/opportunity factors

- The approach presented is limited to information that is material and specific to the entity – that is, risk/opportunity factors linked to the key intangibles (whether or not specified) according to the entity's business model.
- The disclosure should include a description of the risk/opportunity, relevant measures reflecting the risk/opportunity if relevant (for example, KPI's used to measure it) and how the risk/opportunity is managed and mitigated or taken advantage of.
- The factors should be limited to those that are material for the primary users of financial statements. The information should include an assessment of the materiality of the risk/opportunity factors based on the probability of their occurrence and the expected magnitude of their impact. Each of the risk/opportunity factor should be described, explaining how it affects the entity.

WAY FORWARD, CHALLENGES AND ISSUES FOR POSSIBLE SOLUTIONS

- When examining how to provide better information on intangibles, consideration should also be given to:
  - whether it would be beneficial to establish a **common terminology**;
  - how to provide useful information but at the same time **not require entities to disclose information that is commercially sensitive**;
  - **where the information should be provided** (financial statements? management report? somewhere else?);
  - whether the approach to providing information on intangibles could **affect** an **entity's access to finance**;
  - whether some of the **current requirements** can be **removed**.

NEXT STEPS

Constituents’ input sought on the way forward

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- The Discussion Paper does not express any preferences on which of the approaches considered, or combination of them, should be the way forward for providing better information on intangibles.
- Input on the way forward sought from constituents.

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