EFRAG research on Intangibles: Status update and contents of the Discussion Paper

Objective

1 The purpose of this paper is to provide a status of the project on intangibles by summarising the input received from the EFRAG Advisory Panel on Intangibles (the 'API'), and ask for EFRAG TEG's comments and guidance for the preparation of EFRAG's discussion paper(s).

Contents of the Discussion Paper

2 This paper illustrates, on the basis of the inputs collected so far by the EFRAG Intangibles team, the proposed contents of the Discussion Paper.

3 The first part would provide an overview of issues with the current information requirements.

4 The second part would provide a preliminary assessment of possible approaches: recognition (and measurement) and disclosures. Below we report a few inputs from the work done so far:

5 With reference to recognition, the work of the API has allowed to identify possible alternatives to the current recognition (and measurement) requirements for internally generated intangibles. Regarding the possible recognition of internally generated intangibles, most API members (both users and preparers) supported an approach aligned to the one currently included in IAS 38 (or something very similar). A question for EFRAG TEG is accordingly, whether it would be useful for EFRAG's discussion paper to consider alternative recognition requirements.

6 With reference to disclosures, the focus of the discussion paper would be on disclosures in the financial report (i.e. the notes to the financial statements and the management commentary). Below we report few inputs from the work done so far:

(a) It is worth noting that the discussion of current practices put in place by API members or other players in their respective markets in order to overcome the issues with reporting for intangibles, has revealed that market practitioners use disclosure in other communications (such as communications to the investors' community), i.e. outside financial reports;

(b) The work of the API has resulted in a list of information that has been identified by one or several API members as being in practice useful for the three types of industries that have been considered. To date (and in this Agenda Paper), these lists appear quite raw (just lists the various input received). Some of the questions for EFRAG TEG relates to how this information could be processed for the discussion paper (e.g. whether it would be useful to conceptualise them and prepare some general guidelines for what information would be useful on intangibles based on the input received, and whether the discussion paper should already include an attempt to do so).

(c) The work of the API has also allowed to identify some issues with disclosures on intangibles. Questions for EFRAG TEG thus ask whether EFRAG's discussion paper should present suggestions on one or several of these issues (for example, whether EFRAG's discussion paper should define some KPIs and/or provide guidance on the terminology used when communicating on intangibles);

(d) A first dimension of the analysis would consider disclosures directly related to the value of a particular intangible (such as: the economic life of the intangible (if relevant); the selling price of products developed based on the intangible; and the type of the intangible (whether it would need to be replaced; whether it is maintained through the operation of the entity; and whether it tends to increase in value when being used by customers);

(e) A second dimension of the analysis would consider information about the factors that could affect the value of intangibles (e.g. what the entity is doing in relation to environment issues) and with investments/maintenance of intangibles (for example, staff training costs; research costs; marketing costs per brand; and information on marketing campaigns).

7 The last section would deal with challenges and issues to be considered in identifying possible solutions. While some of the suggestions related to recognition and disclosures have been proposed by members of the API with a preparer background and some of the proposals of API members with a user background have been adapted to take concerns of preparers into account, some of the suggestions presented in this paper represents wishes from users. Some of the issues to be considered related to the proposals are accordingly the costs for preparers of preparing and providing the suggested information.

Problems with the current information

Issues previously identified

8 In April 2020, EFRAG TEG discussed a paper identifying the issues with providing information on intangibles. The paper is available here. The paper listed the following issues[1] related to the current accounting framework in IAS 38 *Intangible assets* (so called "first circle"):

(a) Studies show that the value relevance of financial statements is decreasing;

(b) Because many internally generated intangible assets are not recognised, it is argued that financial statements no longer reflect the underpinning drivers of value in modern business;

(c) Not recognising many types of internally generated intangible assets distorts performance measures;

(d) The fact that recognition of intangible assets depends on how the asset has been acquired reduces comparability;

(e) The reliability and relevance of some separately recognised intangibles acquired in a business combination is questioned by some users. Evidence of that was provided during the joint TEG-User Panel meeting in March 2020;

(f) Measurement at cost may be problematic and does not reflect the value of intangible assets, but measurement at fair value may also be problematic;

(g) When discussing the issues with EFRAG TEG, it was noted that the discussion paper should also consider the interactions and boundaries of IAS 2 Inventories and IAS 38 Intangible assets as the identification of the relevant

[1] Not everybody would agree that there is a problem related to all the issues listed.

standard to some transactions is not always straightforward (see recent submissions to the IFRS Interpretations Committee).

9 The April 2020 paper also identified issues with providing meaningful financial information on drivers of value for intangibles that cannot be recognised (so called "second circle") and with non-financial information regarding intangible assets or related factors (so called "third circle"). A few TEG members considered that the project primary focus should be on financial information (circles 1 and 2 in the paper). Conversely, others considered the distinction between financial and non-financial information in circles 2 and 3 was more and more blurred. It was noted that, in the MCPS project, the IASB had already outlined the importance of some non-financial information (such as ESG matters) that may be useful in some circumstances to 'supplement and provide context for the information in the financial statements'. As noted above, the work of the API members so far has led to the identification of two different dimensions (as opposed to circles 2 and 3) when looking at the current practice (information directly related to the value of a specific intangible and information on factors that could affect the value of intangibles).

Additional issues identified by the API

10 When discussing the issues with the API, it has been noted that another issue with intangibles is that, unlike tangible assets, some intangible assets increase in value as they are being used (for example, some software platforms).

11 Other practical issues with the current requirements, mentioned by the API include:

(a) The boundaries between different intangible assets is difficult and interpreted differently (e.g. there are different interpretations on what development costs are). Similarly, it is unclear what the unit of account to be considered is (for example, a movie production includes many different types of rights such as author rights, music rights and graphical rights – should these different rights be considered as separate intangible assets?);

(b) It is not always clear when an asset should be considered as a pre-payment of something or an intangible asset (e.g. is a payment for the right to be able to broadcast an event a prepayment or the purchase of an intangible asset?);

(c) Intellectual property licences acquired – IAS 38 deals with the right to use a licence, but not with the right to receive access to a licence, notably on the cloud in the software industry (software as a service arrangement issue);

(d) How to assess 'control' in relation to certain intangible resources (e.g. different interpretations exist on whether control should be assessed in relation to the use of the asset or in relation to the underlying resource);

(e) Shortcomings in the requirements of IAS 38 regarding their application to intangible assets linked to digitalisation. This has been highlighted in two recent IFRIC Updates (March 2019 on Customer's Right to Receive Access to the Supplier's Software Hosted on the Cloud – AP7; September 2018 on Cryptocurrencies – AP4).

Possible approaches

12 This section summarises the discussions of the API on how better information can be provided on intangibles. The section considers first input on whether more (or fewer) or other intangible resources should be recognised in the statement of financial position compared to the current IFRS guidance. Secondly, this section considers direct and indirect disclosures on intangible resources. The discussion on disclosures does not distinguish between information to be disclosed in the notes to the financial statements or in the management commentary; however, the discussion focuses on what information should be presented in the financial report – and not, for example, in material presented on investors' days. Discussions with

the API members on financial statements versus management commentary till be treated in next steps.

1. Recognition (and measurement) in statement of financial position

13 Currently, given the requirements in IAS 38, the internally generated intangible resources that are most important for entities in the industries on which this research project is focused (see paragraph 0 below) are not (always) recognised in the financial statements.

14 On the one hand, it could be argued that this is an issue that contributes to financial statements becoming less relevant. On the other hand, it could be argued that recognition may not be the most useful manner to provide information on these resources.

15 The API members do not consider that the statement of financial position should try to explain an entity's market value. The financial report should on the contrary inform about the assets the company is using to create that value. Accordingly, not all the intangible resources used by an entity should be recognised (and measured at fair value) in the statement of financial position.

16 EFRAG API members, however, have different views on which intangible resources should be recognised in the statement of financial position, including the approach to be chosen, and how these should be measured. The various suggested approaches are summarised below. The suggestions have been ranked by the EFRAG Secretariat starting from the approach that might result in most internally generated intangibles to be recognised – however, which approach will result in most internally generated intangibles being recognised for a particular entity will depend on facts and circumstances.

17 The description below is focused on what information would be useful to include in the statement of financial position, and does thus at this stage does not consider:

(a) the effects in the statement of financial performance of changes in fair value of a recognised intangible assets; or

(b) the effect resulting from an asset measured at cost not meeting the requirements for being recognised when development begins.

All intangibles should be recognised (if relevant) (suggestion from a user):

Internally generated intangibles should be recognised based on a relevance criterion and measured at fair value. This would generally mean that all of the following should be recognised:

(a) internally developed products on the market;

(b) internally developed products still under development;

(c) royalty streams from out licensed products;

(d) profit-sharing agreements and co-development alliances;

(e) research;

(f) know-how;

(g) assembled workforce;

(h) key employees;

(i) collected data on how people react to different drugs;

(j) brand name;

(k) customer and partner relationships;

(l) customer database;

(m) marketing field-force; and

(n) developed technology/software.

(This proposal could result in recognising intangibles that would not meet the definition of an asset included in the IASB's Conceptual Framework for Financial Reporting)

Same criteria as in IFRS 3 plus reliable measure criterion and more likely than not that its value will be recovered (suggestion from valuator)

Internally generated intangibles should be recognised if they are (i) controlled and identifiable, (ii) they can be measured reliably and (iii) it is more likely than not that they will be recovered. This would generally mean that all of the following should be recognised:

(a)[2] internally developed products on the market;

(b) internally developed products still under development;

(c) royalty streams from out licensed products;

(d) profit-sharing agreements and co-development alliances;

(e) research;

(i) collected data on how people react to different drugs;

(j) brand name; and

(n) developed technology/software.

The basic reasoning behind these suggested criteria is to recognise all the internally generated intangibles that would be recognised if acquired in business combination.

The recognised intangibles should initially and subsequently be measured at fair value.

Recognise if the asset can be sold and has a commercial value (suggestion from a preparer)

Internally generated intangibles as well as intangibles acquired (in a business combination) should be recognised if they can be sold and have a separate commercial value. This would generally mean that the following should be recognised:

(a) internally developed products on the market;

(b) internally developed products still under development;

(i) collected data on how people react to different drugs;

(j) brand name (to the extent it is separately sellable);

(n) developed technology/software (to the extent separately sellable).

[2] These letters (a), (b) etc. are used for the similar items as in the first proposal (all intangibles should be recognised). Accordingly, jumps in the order thus reflect that not all intangibles should be recognized according to the proposal.

Measurement should be at cost or fair value (both at initial recognition and subsequently) and if cost cannot be measured reliably (for example, for collected date on how people react to different drugs).

Similar to the proposal above, the suggestion would mean that the recognition requirement would be similar for acquired intangible asset and internally generated intangible assets. This would also mean that goodwill from a business acquisition is not recognised (but would have to be expensed in the period of acquisition (or deducted equity directly).

Recognition if identifiable within the entity's value creation process (suggestion from a user)

Internally generated intangibles should be recognised based on identifiability within an entity's value creation process. That is, to the extent that it is possible to, for example, attach a rate of return to the investment. This could result in the following internally generated intangibles being recognised:

(e) research (measured at cost);

(f) know-how (measured based on the revenue it will generate);

(j) brand name (measured based on the revenue it will generate);

(k) customer and partner relationships (measured based on the cash flows from these);

(l) customer database (measured at fair value); and

(n) developed technology/software (measured at cost).

(This proposal could result in recognising intangibles that would not meet the definition of an asset included in the IASB's Conceptual Framework for Financial Reporting)

Recognise if it would be possible to sell the asset or it results from a contractual right and the cost can be determined reliably (suggestion from a user)

Internally intangible assets that could be sold separately or result from a contractual right should be recognised on the statement of financial position if they can be measured reliably at cost. The argument is that this is necessary from a stewardship point of view as these assets would then have to be reviewed and assessed for impairment by the management. In addition, the information would be useful for creditors' recovery analyses. The principle could mean that the following should be recognised:

(a) internally developed products on the market;

(b) internally developed products still under development;

(e) research (to the extent it would be separately sellable);

(f) know-how (to the extent it would be separately sellable);

(i) collected data on how people react to different drugs; and

(n) developed technology/software.

For assets acquired in a business combination, the same criteria should be used to identify which assets should be recognised separately from goodwill.

	Under this approach an internally generated brand would generally not be recognised as it would be difficult to determine which costs relate to creating the brand. With reference to the measurement basis, the API member suggestiong this approach considers fair value measurement to be very subjective and result in increased volatility. This approach would accordingly require measurement at cost with impairment test (no amortisation) (this should also apply to intangible assets acquired (in a business combination). The proposal should be seen together with a possible disclosure requirements to distinguish between costs used for maintenance and investment.
	Do not change the recognition requirements (preparers, valuators, users (approx. half of the API members presenting a view on the issue)) Arguments of API members for not changing the current recognition requirements for internally generated intangible assets include: - Measurement at fair value (which would be the relevant measurement basis) cannot be done reliably; - Recognising additional internally generated intangible assets would result in implementation issues (for example, in relation to measurement, amortisation period, time of recognition and how to account for continual 'improvements' or 'maintenance'); - Disclosures provide more useful information than a number on the statement of financial position; - The different accounting treatment between the recognition of intangible assets acquired (in a business combination) and internally generated intangible assets is appropriate as the value of acquired intangibles has been confirmed by a third-party transaction and because the management needs to be held accountable for the amount it has spent on the (business) acquisition; - Disclosures can help users compare entities growing by acquisition with those growing organically; - It would be costly for preparers to recognise more internally generated intangible assets; - Allowing more items to be recognised could make earnings management easier.

18 As it appeared from the list above, some API members with a user background have been critical about having the fair value of a particular intangible resource included in the statement of financial position. They consider that it would be difficult to convey the value in a single number, for example, the NPV of a drug, because of the number of inputs subject to uncertainty and variation over time. In addition, it has been noted that the value of individual intangible assets may be of little relevance as intangible assets work together[3]. Most intangibles do not have an intrinsic value as they only create value in the context of a specific business in a specific environment. Entities should not try to provide a single number. Analysts

[3] This comment was also made in relation to the relevance of the information following the purchase price allocation in business combinations.

could estimate a range of outcomes and then make a call on whether the risk/reward profile is positive. Requiring the reporting entity to measure and disclose the fair value of its intangible assets might also not be useful, because it would result in asking entities to predict the entire future. Also, it would result in significant fluctuations, which some users do not consider useful.

Other proposals considered[4]

19 The recognition criteria for intangibles was considered in the FRC's discussion paper *Business Reporting of Intangibles: Realistic Proposals* which has previously been considered by EFRAG TEG and EFRAG CFSS. It was proposed in that paper that an intangible should be recognised at cost and only when (i) the costs to be incurred on development can be estimated at the time the project is undertaken and the amount capitalised should not exceed these estimated costs; and (ii) economic benefits to be derived from the intangible can be specified when costs are first incurred. It is noted in the FRC discussion paper that for many intangibles the measurement uncertainty of fair value is so great as to call into question whether it could provide a representationally faithful depiction.

20 When discussing the FRC paper, EFRAG TEG and EFRAG CFSS members expressed mixed views about the need to revise IAS 38 *Intangible Assets* or address reporting about intangibles more broadly. One suggestion was that IAS 38 could be examined to see whether the definition of an intangible asset was in line with developments of new technologies. It was noted that intangibles, by some, had been identified as one of the key issues for improvement. However, it was important and challenging to determine how users consumed the information. Discussions on intangibles was, however, difficult because different people gave 'intangibles' different meanings and there was a huge spectrum of views.

21 When discussing the FRC proposal with API members, it was appreciated that the proposals did not result in the need to recognise more intangible assets in statement of financial positions and the approach was considered less disruptive and consistent with the existing Framework.

2. Disclosure in financial reports

22 As noted above in paragraph 13, many internally generated intangible resources are not recognised. Instead a solution that has been applied in practice (e.g. by pharmaceutical companies) has been to disclose qualitative and quantitative information that help users develop their own estimates of present value of the cash flows expected from internally generated product-related intangibles. Currently, much of this information is, however, not presented in the financial reports, but reported in other communications with the investors.

23 Discussions at the EFRAG API and other initiatives on intangibles have shown that information about intangibles can be provided to users of financial statements both directly and indirectly. That is the information can relate to either:

(a) an item of the stock of intangible resources (direct information);

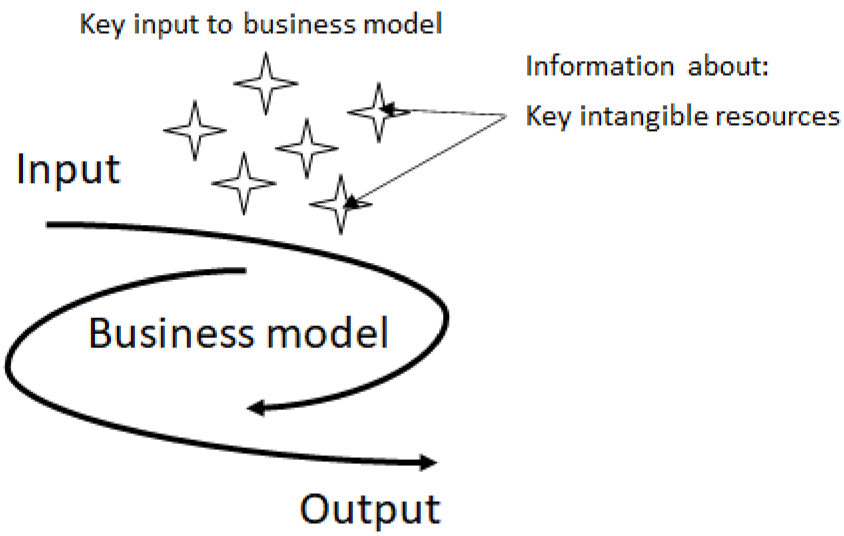
(b) factors affecting an intangible item, several intangible items and activity or the entity in general (indirect information).

The factors that can affect an intangible item can be both 'investments' in intangible resources and other decisions and external factors.

[4] Recognition, in relation to methods to minimise mismatching in the statement of profit or loss, is also considered in the paper presented at the 2020 IASB Research Forum. The paper has not been considered so far by EFRAG TEG and the API. A short summary of the paper is provided in Appendix 3 as background.

2.1 Direct information in financial reports

24 From discussions with API members, users/valuators have generally found that information on the key (or core) intangibles, derived from the entity's business plan and with a link with financial performance measures would be useful (see illustration below). However, one API member with at preparer background noted that identifying the key intangibles of an entity could be judgemental.



25 The information provided should include a narrative description of the entity's business model and its value drivers, as well as quantitative KPIs to assess these value drivers. In order for users to be able to use the KPIs for peer analyses, some kind of standardisation (e.g. at sector level) would have to be introduced.

26 In addition, a member of the API with a user background suggested that forward-looking information on the business model should be presented.

<u>List of intangible assets in the selected sectors</u>

27 In the three groups of industries represented in the EFRAG API, the table below lists the intangibles that were identified as being particularly important. Depending on the entity's exact business model (including whether it is business-to-business or business-to-customer), the following factors could thus be key intangible resources.

Interactive media and software industry

- Technology/software
- Master copyrights
- Customer base/relationships subscriber base
- Customer attention rate

Pharmaceutical industry

- Internally developed products on the market
- Internally developed products still under development (the "pipeline")
- Royalty streams from out-licensed products
- Profit-sharing agreements and co-development alliances
- R&D technology, know-how and assembled workforce/key scientists
- Manufacturing technology
- Data (e.g. on who certain drugs would work on and who it would not work on)

- Brand (particularly for products that er not prescribed by doctors, but in general important to have a good name for relationships with partners and when entering new markets)
- Reputation
- Customer and partner relationships
- Marketing field-force (i.e. people who can explain the product to doctors)
- Key management personnel (including leading scientists)
- Management philosophy and culture

Fast moving consumer goods and luxury goods

- Brand (including trade names and trademarks) – most important
- Customer relationships
- Technology

<u>Possible disclosure requirements (direct information)</u>

28 For these potential key intangible resources (and for material intangible assets recognised on the statement of the entity's financial position (to the extent these are not key intangible resources)), API members have identified the following direct information as useful[5]:

General (for each key intangible resource (and intangible assets recognised in the statement of financial position) for which it would be relevant):

- Information on whether the intangible resource is operating or non-operating (that is whether the intangible would need to be replaced (such as software development) or would not need to be replaced – but would need to be updated (such as a customer database). (A split between those acquired and those internally developed could sometimes be a proxy for this – but it would not work in all cases).
- Information about whether the intangible resource is related to products (tangible intangibles) or to customers (intangible intangibles).
- Information on the remaining useful life of the intangible (if relevant).
- If a value of an intangible resource is provided (either in the notes or on the statement of financial position): The valuation method, including key assumptions used in the estimation and key inputs should be provided.
- Linkage between intangibles recognised in the statement of financial position and profit or loss or cash-flows.
- Information about legal and contractual rights associated with intangible resources, including whether an intangible resource is (legally) owned by an entity.

Information related to brands

- Disclosure on development in brand value, including the costs necessary to maintain the brand value.
- Revenue related to each trade name.

Customer relationships (and similar)

- Customer attrition rate and customer feedback.
- Information on relationships with subscribers (interactive media and software industry).

Development costs (recognised on the statement of financial position)

- Disclosure on what capitalised development costs include. For example, development project could, among other things, result in

[5] An item on the list has been included if just one API member has considered it useful.

a patent and a technology and other intangibles and it would be useful to present this separately to make the financial statements more comparable with the information presented if the patent would have been acquired.
- Details on capitalised development costs including expected economic life.

Management/employees/culture
- Employee turnover per function and geography and employee feedback.
- Information on management quality and trust in management by e.g. displaying a management turnover ratio.
- Information about company culture including what types of people the entity is trying to hire (to understand e.g. whether a company is focusing on sales or development – or a combination).
- Intangible liabilities (e.g. would the company be worth more if it would be split up (complex structure is an intangible liability).

Intellectual rights/patents
- Information on patents including expiration information and expected economic life.

Market field force (pharmaceutical industry)
- Information on which prescribers could be reach with the field force (information which is sometimes provided by entities outside financial statements)

Internally developed products (pharmaceutical industry)
- Information on life-cycle management of a developed drug.
- Information per drug on:
  - The patient population for a drug (target population)
  - Number of patients have been treated with the drug
  - Countries in which it has been approved
  - Selling price
  - Reimbursements in different jurisdictions
  - Competing drugs (existing and under development)
  - Safety information
  - Market share and projections on market share
  - Lifecycle plans (including whether the life of the drug can be prolonged)
  - Return on investment.

<u>Issues with the list of possible requirements</u>

29 Although the above information is considered useful by one or several API members, API members have also identified issues related to providing the listed information in the financial reports.

30 Although the information would be most useful if it is linked with financial performance measures, it is noted that some intangibles may have such an indirect impact on the performance that it may be difficult to provide information linking the resource to performance measures.

31 On the information on whether an intangible is operating and non-operation, it is acknowledged that it may not always be completely possible in practice to distinguish. For example, a customer list could be both an operating and a non-operating intangible depending on the context (the strategy of an entity). It is also noted that divergence exists in practice on which internally generated intangibles are recognised. As long there is room for clarification on this issue, the value of the information on the part of intangible assets that are acquired and the part that are internally developed will be reduced.

32 Although some information could be provided in financial reports to help assess factors like trust in management; management quality; and employee feedback much of this information would still have to be collected from other sources. For example, API members with a user background have noted that management trust is assessed by comparing previous statements with actual results, by assessing the management's voice and other assessments based on feelings and emotions and by assessing if the plans of the management seem realistic for the company (e.g. it would impair trust if a small biotech company would say that they would build their own sales force). Similarly, although an entity could disclose information on employee satisfaction surveys, analysts might not find this information particularly reliable as there are examples of entities paying bonuses to employees if they work in the department of the entity with the highest employee satisfaction. An API member accordingly expressed that it could be preferable to use external information on such an issue (currently, for example, analysts look at review of employees posted on the Glassdoor website[6]).

33 A comment from an API member with a preparer background has been whether the information should be placed in the financial statements or in the management commentary. In that regard it is expected that the IASB will propose, in its draft *Management Commentary Practice Statement* that the entity should disclose information to help investors and creditors understand the entity's key resources and relationships that are fundamental to the entity's ability to create value and generate cash flows[7].

<u>API reactions to the FRC and the KASB proposals of direct information in financial statements</u>

<u>KASB</u>

34 A specific proposal for direct information on core intangibles has been put forward by the Korean Accounting Standards Board (KASB). EFRAG TEG has previously considered this proposal which advocates for a report of unrecognised intangible assets that has the same level of importance as recognised assets[8].

35 The idea is that there would be a definition of 'core intangibles' – those intangibles that are the main driver of the company's value. These intangibles should be valued at fair value and presented in a separate statement to be provided in the notes to the financial statements: the Statement of Core Intangibles (SCI)'. The SCI would provide monetary valuation of core intangibles in a separate report, including basis of preparation; main assumptions; key valuation inputs and assumptions.

36 Core intangibles were tentatively defined as intangible factors that are important to an entity in its creation of value, whether or not they are secured by legal means and whether or not they meet the current accounting definition of 'assets'. These are important intangibles that could affect the market as it continues to generate excess profits in relation to the reporting company's (value creation) primary operating activities, and if the information is (important) omitted or misrepresented, it effects information user's decision making (e.g. description on gap between market value and book value).

37 When EFRAG TEG and EFRAG CFSS considered the proposals of the KASB, it noted concerns with the relevance and reliability of the fair value information and the cost associated with measuring some unrecognised intangibles at fair value. It

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[6] Glassdoor is a website where current and former employees anonymously review companies. Glassdoor also allows users to anonymously submit and view salaries as well as search and apply for jobs.

[7] A short overview of the expectations relating to intangibles in the IASB's proposal for the Management Commentary Practice Statement is included in Appendix 2.

[8] The proposal has also been considered by the IASB's Accounting Standards Advisory Forum. A summary of the comments made at that occasion is included in Appendix 1.

was also noted that the proposed approach, if applied to non-separable intangibles, in some cases could result in double counting of resources. However, it was at the same time noted that the identification and disclosure of core intangibles was helpful and that the related disclosures could provide useful information.

38 It was recommended that the KASB should reach out to users to assess whether they would find the suggested information helpful.

39 When presenting the KASB proposals to the API some API members with a user background considered that a separate statement on intangibles such as the one suggested by the KASB was useful and probably would be the way forward in the longer run (5 to 15 years). The statement, which borrowed the format of an analyst report, would be useful for users who do not have access to analyst reports. Although a limitation was that the statement did only provide the values of intangibles at a point in time (which could be outdated by the time the statement would be made public), examination of changes in the values from year to year would provide dynamic information on the value creation process.

40 Similar to EFRAG TEG, some API members considered that users were not so much interested in the management's valuation of individual assets as they had their own models to assess the value of an entity as a whole. However, narrative information about both the value development/maintenance process and information about the model, assumptions and inputs were considered essential to complement the numerical information resulting from this statement. For example, in order to understand the value development process in case of a customer list or a brand, it would be important to know how the marketing plan has been designed and implemented, when it did start, in which forms it was pursued, how many clients/households were involved etc. Similarly, for the valuation models/inputs/assumptions, the example of IAS 36 disclosure on value-in-use assumptions and judgement was considered a possibility.

41 API members considered that both cost and forward-looking information would be helpful.

42 The ability to reconcile the information in the statement with the financial statements was considered essential. It was also important to find ways to temper bias towards management's over-optimism in evaluating the intangibles.

43 Preparer members of the API expressed more reservation on the basis of complexity and uncertainties in measuring the current value of intangibles. For some it was not the role of preparers to provide such forward-looking information and this could also be in conflict with local regulations prohibiting the provision of such information. Complexity issues mentioned include the frequency of production of the information, the commercial sensitiveness or even the possible legal issues (e.g. if the intangible is finally sold to a materially different price) and the cost of producing the information.

44 Fair values of intangibles were often based on models rather than observable prices and this limited the relevance of the information. One API member considered that cost, reflecting a real market transaction at a point in tile, was more informative than fair value based on such models.

45 Other API members with a preparer background supported the principles behind the proposed statement but would prefer such statement to be in a narrative form and not try to provide precise fair value measures. A possible approach could also be to provide sensitivity analyses.

<u>FRC</u>

46 The discussion paper of the FRC (see paragraph 19 above) did also consider direct information on intangibles. According to the proposal, management should select the intangibles that are discussed in narrative reporting by reference to those that

are most relevant to the entity's business model. The narrative reporting should include metrics and they should be reported for several reporting periods to enable trend analyses. Rather than attempting to provide a value in narrative reporting, the entity should provide information that enables investors to make their own assessment of intangibles and their impact on financial performance. For example, rather than attempt to quantify the value of customer loyalty, metrics that are relevant to it could be disclosed. Management should comment on the factors that have caused metrics to change and compare the reported metrics with their realistic targets and the metrics could be standardised within specific industries.

47 When discussing the FRC proposals EFRAG TEG and EFRAG CFSS[9] members noted that there were many current initiatives on intangibles including in the space of non-financial reporting, and this had the potential to create confusion. Some members noted the importance of first understanding how information on intangibles was used.

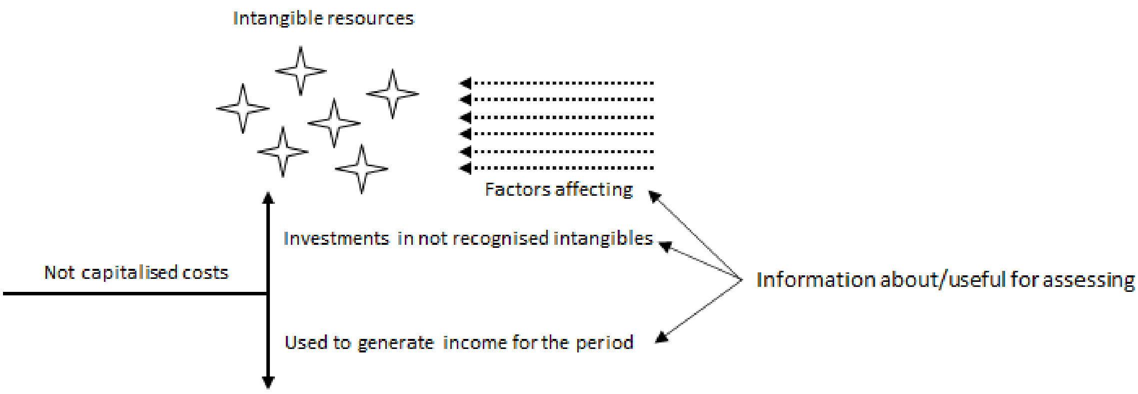
48 When discussion the FRC proposals with the API, several respondents specifically noted the importance of focusing on those intangibles that are critical to the business model and value generation and disclosure of metrics standardised by industry with some support for the WICI industry-based metrics and 'inverted pyramid' approach to support comparison across companies supplemented by some entity-specific measures. Concerns were, however, voiced by preparers around the commercial sensitivity of the information and the costs of compliance.

2.2 Indirect information in financial reports

49 Indirect information d boes not provide direct information that can be used to assess the value of a particular intangible resource. Instead the information is either explaining:

(a) How the expenses recognised in a period relate to the income of the period or to investments in not recognised intangible resources;

(b) Factors potentially affecting a single, several or all of the entity's intangible resources.



50 Whereas direct information relates to specific (key) intangible resources, it may be less clear which intangible resource(s) indirect information is related to.

51 Although the information is not directly related to a specified intangible resource, it can be used to estimate future cash flows from an entity's activities (and/or assess the management's stewardship). An objective, of some, indirect information is, in addition to providing information on investments in the future, to enable users to perform a better matching between the income of the period and the related expenses.

[9] The proposal has also been considered by the IASB's Accounting Standards Advisory Forum. A summary of the comments made at that occasion is included in the Appendix 1.

52 According to API members, indirect information is, for example, a solution that can be found in the current practice of the pharmaceutical sector.

Possible disclosure requirements (indirect information)

53 For the three groups of industries the following pieces of indirect information has been identified by one or more API members as relevant. As indirect information in many cases is not directly related to a particular intangible resource, the relevant information is provided for industries and not for particular intangible resources.

Not industry specific

- Information useful for distinguishing between future oriented expenditures and maintenance expenditures. The distinction could either be provided:
  - directly by the entity (guidance for the distinction could be based on what expenses would have been necessary in a no-growth scenario) and the information could include current margins if no investments in growth were made.
  - Indirectly by providing information on:
    - expenses by both function and nature (to understand the types of expenses per function)
    - staff training costs (not included in research and development costs or sales and marketing costs)
    - how the tax information relates to intangibles
    - employees per function, segment and region (to find out what people are doing, where they are doing it and how much they are paid)
    - a disaggregation of depreciation and amortisation on what assets they relate to (in order to provide information about the expenses relating to assets that are replaced by internally generated assets)
    - better segment reporting. Often more detailed analyses are provided in analysts presentations than in the financial reports.
- Information on marketing expenses, including how marketing expenses are distributed by market and by brand.
- Information on spending on patents and trademarks.
- Disclosure of research costs.
- Employee costs and numbers of employee per function and costs of consultants per function.
- Information about when the benefits from future oriented expenditures would arise and for how long the benefits would last (e.g. when the benefits of research or marketing would be expected to start and end).

Interactive media and software industry

- Information on it-investments.

Pharmaceutical industry

- Information on marketing campaigns.
- R&D costs and split per area and per development phase.
- Cash spent on R&D.
- Royalty expenses (and the line items they are included in in the statement of profit or loss).
- Expenses/investments incurred and already recognised in the financial statements and used to develop internally generated intangible.

- Information on when pay streams to third parties would end.
- Marketing expenses split per brand.
- Information on costs to maintain market shares in markets.
- Details on partnerships (e.g. who is the developer, who contribute what, who has control of manufacturing, who can sell in which market?).

Fast moving consumer goods and luxury goods

- Marketing expenses and how there are split between geographical areas and on the different brands of an entity.
- Market growth.
- Price development.
- Market share changes.

<u>Issues with the list of indirect information</u>

54 Although the above information is considered useful by one or several API members, there are also some issues related to providing the information in the financial reports.

55 On the proposal to distinguish between expenses that are future oriented and maintenance expenditures, it is acknowledged that it could be difficult, as it could be argued that any expense would be future oriented. Even money spent on running the business now could be argued to be future oriented as it could be necessary to run the business now in order also to be in business in the future. Guidance might be developed based on the expenses that would be necessary to keep the business in a steady state.

56 Also, it could be difficult to relate tax expenses to items that are future oriented and items that are not. Guidance would accordingly have to be developed and the distinction could be different between industries.

57 The FRC discussion paper (see paragraph 19 above) also included a proposal on separate disclosures of expenditure on 'future-oriented intangibles', that is expenditure which is incurred with a view to benefitting future periods, which is currently written off as a matter of accounting policy because it does not result in an item that meets the definition of an asset or fulfil the recognition criteria. Similar to the concerns expressed above, API members expressed concerns that disclosures may be highly subjective and involve significant management judgement in identifying 'future-oriented expenditure. Some API members noted that expenditures on assets (to generate future earnings) are often also related to current earnings, particularly with intangible assets. For example:

(a) Customer loyalty may be generated by sales discounts, an explicit expenditure that is embedded in revenue.

(b) A bonus to employees may be investing in human capital, an incentive to stay with the firm as well as wages for current service.

(c) Advertising can generate future sales (brand building) but can also be for current sales.

58 In all the above cases the asset component (that is the part of the expense relating to future earnings) is difficult to identify and separate from the component related to current earnings/maintenance expenditures.

59 Furthermore, many entities presented their income statement by function rather than by nature and the type of breakdown information suggested by the FRC's would not be easy but costly to identify.

60 One API member with a user background suggested that the focus should be on 'unusual' amounts of future oriented expenses rather than attempting to separate recurring future- oriented expenses such as training or marketing.

61 On the proposal to have segment reporting as per presentations to analysts in the financial statements, it is noted that this could have some stewardship liability implications for management, which would accordingly be reluctant to provide the information.

Information about human rights, governance, environment, supply chain

62 API members referred to the disclosure in the financial report of the following (across sectors):

- Information on what the entity is doing in relation to:
  - Human rights (labour standards, worker rights, non-discrimination and participatory workplace environments - including the number of years the entity has had a policy on this)
  - Accountability to all company stakeholders (employees, communities, investors and civil society – through, for example, social and environmental disclosure)
  - Governance (e.g. board diversity)
  - Relations with the community (e.g. how the entity partner with communities to help ensure a qualified workforce, adequate infrastructure and location of facilities)
  - Environmental stewardship
  - Supply chain management (e.g. through adherence to codes of labour practices, factory audits and disclosure of contractor factories)

63 What the entity is doing in relation to human rights; relations with the community; environmental stewardship and similar, could affect intangible resources such as the entity's reputation, brand, workforce, customer loyalty, adaptability and alliances. However, it has been noted that from the perspective of a user of financial statements, the information could be difficult to interpret, as sustainability is a 'double-edged sword' (i.e. something that could have both favourable and unfavourable consequences) in the valuation process. In principle, the entity's future development should be better for an entity that incorporates these factors into the business model and operations. Nevertheless, there are implementation risks that could destroy value. For example, it would be beneficial for an entity to hire the best people despite gender. On the other hand, in order to improve the gender balance, for entities to show that it is not discriminating, it could choose to only promote a given category of workers. This would harm the success of the entity as the workforce would be undermotivated and the company would not have the best people. To avoid the disclosures becoming a "green-washing exercise", it has been suggested to standardise it. Information about how long an entity had followed a particular policy on e.g. gender equality, how long time the people had been employed, information about bonuses on the people managing the sustainability goals at the operational level and the goals these people need to reach. For example, if the bonuses of the management of a company depends on the number of injuries of employees, it can be assumed that the company is doing a lot to prevent employees to be injured. There would also be many aspects to consider in relation to the various factors. For example, it is important for many companies to keep their people. One aspect of this is talent management, but another factor is where the company is located, and the career prospects the company can offer.

64 Factors that could affect an entity's intangible resources may not affect a particular intangible resource. However, different factors may have different importance for different entities. Accordingly, the importance of the factors depends on the business model, and it has therefore been suggested that the factors should be explained in relation to the entity's business model. The disclosures could, perhaps to some extent, be similar to some of those disclosures on risks specific and material to an entity, entities are providing in their (Universal) Registration Documents[10] (and for which ESMA has developed some guidance) and in accordance with the EU's Accounting Directive in the management reports.

2.3 Information outside financial reports

65 From discussions with API members, it has appeared that additional direct and indirect information on intangibles may be currently found outside the financial statements (and in many cases also outside the management commentary). Instead the information is presented for investors at, for example, investor days. At API meetings, there have been discussions between users and preparers on whether this information could be placed in the financial statements.

66 From the preparers' perspective, it has been argued that it could be hard to make information about the items at a quality that could be filed to regulators and it could also be costly to have it audited. It has also been argued that it would take time to prepare the information and that could accordingly delay the publication of financial statements. On the other hand, it has been argued from a user that some of the information easily can be prepared well in advance of the finalisation of the annual report and that some of the information currently provided on intangible assets acquired in a business combination could be scrapped as it was anyway stripped out by analysts (to make data comparable with data from internally generated intangible assets) in order for entities to have time to prepare the better disclosures (not all users/valuators agree on the comment that information currently provided on intangibles acquired in an business combination should be scrapped – instead the information could be made more useful[11]).

Challenges and issues to be considered in identifying possible solutions

Potential effects on the ability to receive finance

67 When considering what assets should be recognised on the statement of financial position (including which assets should be recognised separately from goodwill), some members of the API (mainly valuators and a credit provider) noted that it should be taken into account how it could affect an entity's ability to receive finance (as assets such as research and development in pipeline; brand reputation and customer loyalty might be accepted as collateral (whereas goodwill would not).

68 However, the view has also been expressed by a preparer and a user that it would not have any effect on an entity's ability to borrow money whether more or less intangibles are recognised on the statement of financial position as this would not change the underlying economic situation of an entity and credit providers would remove internally generated intangibles from the statement of financial position when assessing whether to provide a loan.

Terminology

69 An issue with reporting on intangibles, mentioned by several API members, which was also apparent from the literature review commissioned by EFRAG, is that there

[10] Regulation (EU) 2017/112 and Delegated Regulation (EU) 2019/980.

[11] One API member with at user background noted that he had never seen a sell-side report, buy-side report or management commentary where the figures following the purchase price allocation were mentioned. However, some users compared the reported figures on intangible assets with the values reported when the intangible assets were acquired (to check whether they had lost value). It was suggested to make the purchase price allocation more relevant by requiring additional information or more granular information (including clarifying/enforcing current requirements) and by updating the measures

is no fixed terminology when it comes to describing intangible resources. Different words can accordingly be used for the same resource, and the boundaries of what is included in a particular term can differ. The introduction of a common terminology has thus generally been considered as something that could be useful for the reporting of intangibles.

70 The introduction of a common terminology might also clarify how different resources may be overlapping as resources such as those listed in paragraph 25 for the pharmaceutical industry are generally not discrete – but overlapping. For example, a brand name acquired would often encompass the field-force and the business in a particular place. Accordingly, trying to separate the items and put a value on them separately could result in an artificial allocation exercise.

Sensitiveness of the information provided

71 Preparers of the EFRAG API have noted that there would be some limitations on what information can be disclosed. For example, disclosing some types of information about the items listed in paragraph 25 could be used by competitors and could be considered commercial sensitive. Currently some information relevant for the items are provided by some preparers outside financial reporting, for example in press releases. It could thus be considered whether other forms of communication could be better than including information on the items in the financial statements.

Remove requirements that do not result in useful information

72 Some preparers consider that they currently spend a lot of time and money complying with the current requirements related to providing information on intangibles[12] which are not considered particularly useful by many users. Any suggestions to provide more information should therefore be accompanied by a consideration on the usefulness of existing requirements.

Not only focus on the statement of financial position

73 Disclosures relating to intangible items was a balance between stewardship and forward-looking information because it needed to be consistent. The focus should not be only on the statement of financial position because the P&L and the cash flow statement consequences could be more important.

Inputs to develop value rather than FV estimate

74 It would be more useful for analysts to provide granular information of financial records that is relevant to the inputs in financial models rather than coming up with valuations for specific assets.

Auditability and audit costs

75 It should be considered whether the information would be possible to audit (including how subjective the information will be) and whether the cost of having the information audited would outweigh the costs of having it audited. Users of financial statements might, for example, find it useful that the financial statements just includes all information, so that the users would not have to consult different sources of information, but would not attach a high value to the fact that some pieces of information is not audited (e.g. information on expiry date of a patent).

Focus on primary users

76 Only ESG information that would have a significant impact on the entity should be disclosed in order to not make the financial reports less accessible for the primary users of those.

[12] It has, for example, been mentioned that it is very costly to test all the intangible assets that are identified separately in a business combination for impairment / indication of impairment.

Questions for EFRAG TEG

77 EFRAG TEG has previously noted that they would prefer having two separate deliverables as part of the project: One paper describing the problems (without a formal consultation) and another paper discussion possible solutions. This was considered most beneficial for giving visibility to the project and provide insight to respond to the forthcoming consultation on Management Commentary Practice Statement. As both EFRAG's discussion paper on intangibles and the IASB's exposure draft on *Management Commentary Practice Statement* are delayed, would EFRAG TEG support the proposal of the EFRAG Secretariat to issue one single document?

78 Some specific issues with the current guidance are mentioned in paragraphs 11(b) – 11(e). Does EFRAG TEG consider that these issues should be addressed in EFRAG's discussion paper(s)?

79 As it appears from paragraphs 11(a), 11, 31, 69 and 70, the terminology and distinction between different types of intangible resources is not clear. Does EFRAG TEG consider that it would be useful to discuss in the discussion paper the terminology to be used to communicate on intangibles?

80 Paragraph 16 summarises some suggestions on which internally generated intangibles should be recognised in the statement of financial position. The current recognition requirements for internally generated intangible assets is the approach supported by most API members. Does EFRAG TEG consider that EFRAG's discussion paper should include a discussion on some of the proposals other proposals for recognition (or modifications on some of the proposals) (or should the discussion paper focus on disclosures)? If the discussion paper should consider recognition, which proposals should be discussed? In this regard the EFRAG Secretariat notes that:

   (a) A possible approach to discuss would be to recognise those intangible resources that would meet the new definition of asset and can be measured reliably.

   (b) A proposal to split capitalised development costs (or disclose the different elements of capitalised development costs (see paragraph 28) is not considered a proposal concerning recognition (as the recognition requirements under such a proposal could remain similar to those currently included in IAS 38).

81 Paragraph 28 includes the direct information API members identified as relevant in general and for particular intangibles. Does EFRAG TEG consider that it could be useful to try to generalise the suggestions in order to be able to suggest types of direct disclosures that could be useful?

82 Although API members support KPIs to be provided for an entity's key intangibles, API members have not provided many KPIs when explaining what information is useful/they use. Should EFRAG's discussion paper try to further develop/suggest KPIs that could be useful (in addition to those mentioned by API members)?

83 This paper is structured as follows:

   (a) Problems with the current information (following EFRAG TEG's response to the question in paragraph 77, this may be a separate paper)

   (b) Possible approaches

      (i) Recognition in the statement of financial position

      (ii) Disclosures in financial reports

         - Direct information

- Indirect information

(iii) Information outside financial reports

(c) Challenges and issues to be considered in identifying possible solutions

Another structure previously considered by EFRAG TEG has been: (a) information about intangibles in the primary financial statements (i.e. consideration of the issues associated with the existing Standards and Framework); (b) Additional information about past and current value creation process; and (c) Information about the sustainability of value creation i.e. how value creation is maintained and enhanced for the future.

Does EFRAG TEG consider the structure presented in this paper to be useful for a discussion paper, or would they suggest another approach that would, for example, distinguish between past and current value creation and the sustainability of the value creation?

84 What would be the direction of EFRAG TEG for factors that could affect an entity's intangible resources (such as what the entity is doing in relation to human rights and the environments)? For example:

(a) Does EFRAG TEG consider that disclosures on risks specific and material to an entity (see paragraph 64 above) would cover the information needed on the factors affecting the entity's intangible resources (except for information on an entity's investments in non-recognised intangibles) that should be disclosed in the financial reports?

(b) Does EFRAG TEG considers that EFRAG's discussion paper should provide suggestions on how the information could be provided in a standardised manner (including specific KPIs)?

85 To a significant extent, this paper presents separately information that could be useful and issues to be considered in relation to the proposals (including costs for preparers). Does EFRAG TEG consider this to be an acceptable approach for the discussion paper or should the discussion paper present proposals that are weighing the benefits against the costs?

Appendix 1 Comments from members of the IASB's Accounting Standards Advisory forum on KASB and FRC proposals[13]

Korean Accounting Standards Board (KASB) – Statement of Core Intangibles – Discussion at ASAF

86 At their December 2019 meeting, members of the IASB's Accounting Standards Advisory Forum (including EFRAG) discussed the proposals. The following comments were made:

(a) Some members observed some potential challenges that could affect the uptake of the Statement of Core Intangibles (SCI), particularly on a yearly basis, which included the cost and complexity of the valuation exercise.

(b) Valuations in the SCI might be subject to bias in favour of the entity preparing it (i.e. incentive to provide too much of a "rosy" picture) and there could be a conflicting view by an acquiring entity.

(c) Importance of providing information on intangibles that is useful to investors in their own valuation estimate of future cash flows.

(i) Some members considered that it is crucial to demonstrate that investors will find the SCI useful, before considering further the proposal for standard setting.

(ii) They commented that the increasing gap between an entity's book value and market value, often cited by some as a reason to address unrecognised intangible assets, was not a concern generally raised by investors.

(iii) Some members suggested that investors would be interested more in the data used to determine the values in the SCI than in the entity's valuation of its intangibles.

(iv) Investors would also need performance measures related to intangibles, as well as information on the required investment to sustain intangibles, including maintenance and replacement costs.

(v) It would be useful to have a discussion of the risks, opportunities and the related sensitivities affecting intangibles.

87 A clear definition of some of the terms used in the approach (such as 'excess profits' and 'value creation' or 'core intangible assets' and how companies would determine what their core intangibles are. More non-financial information on intangible assets was needed, and it may be difficult to translate such information into reliable monetary values as attempted in the SCI.

Financial Reporting Council - Discussion Paper - Business Reporting of Intangibles: Realistic Proposals

88 At their July 2019 meeting, members of the IASB's Accounting Standards Advisory Forum (including EFRAG) discussed the proposals. The following comments were made:

(a) Some members supported a narrative reporting including metrics such as Key Performance Indicators (KPIs) that can assist users of financial statements in assessing an entity's intangibles.

(b) Some members expressed reservations and concerns about inherent measurement uncertainty relating to intangible assets, and the difficulty in

[13] Comments from EFRAG TEG, EFRAG CFSS and the API on these proposals are summarised in the main part of this document.

identifying future-oriented expenditure. Efforts to provide greater transparency would lead to highly subjective disclosures and involve a high degree of management judgement.

(c) Concerns were also expressed around commercial sensitivity of the information and compliance costs.

(d) Expenditure which is for future-oriented intangibles assets is not always identified. For instance, some entities are reluctant to present or disclose development expenditure as an intangible asset because of the risk of future impairments.

(e) The FRC's work on intangible assets may bring useful input to the IASB Management Commentary project.

(f) Some members supported information on intangibles being reported outside financial statements such as in the Management Commentary. This is because:

   (i) Information on intangible assets is more useful when combined with management's view;

   (ii) Concerns with the recognition criteria for internally generated intangible assets play a less important role when the information is reported in the management commentary; and

   (iii) Disclosures allows flexibility to present information on intangible assets on a quantitative or qualitative basis.

89 Suggestions for the UK FRC to further develop its approach included the following:

(a) Research how information about intangible assets is consumed by users, before considering accounting solutions.

(b) Conduct joint outreach involving users, preparers and standard-setters.

(c) Consider performing outreach and consultation with investors who focus and monitor innovation.

(d) Consider the quality of information about intangible assets before the location where it is reported—narrative section of the annual report or the financial statements.

Appendix 2 The IASB's Management Commentary Practice Statement (MCPS)

90 The revised MCPS will not contain specific guidance on intangibles, but the guidance on resources and relationships will specifically refer to intangible resources and relationships. The proposed guidance would apply to both tangible and intangible resources

91 At its October 2020 meeting, the IASB discussed an overview of the draft MCPS guidance in relation to intangible resources and relationships.

92 It was noted that the working draft of the Exposure Draft included the following guidance to promote provision of information on intangible resources and relationships in the management commentary:

(a) draft guidance on resources and relationships asking for information to help investors and creditors understand the entity's key resources and relationships that are fundamental to the entity's ability to create value and generate cash flows and specifies that resources and relationships include intangible resources and relationships.

(i) Key intangible resources and relationships should be described irrespective of whether they are recognised in financial statements.

(ii) The disclosure objective specifies the following types of information that need to be provided about key resources (including key intangible resources) and key relationships: nature of those resources and relationships; how the entity accesses and deploys them; factors that could affect the availability of the resources and the strength of the relationships; and progress in managing the resources and relationships.

(b) draft guidance on strategy that explains that one aspect of management's strategy may relate to preserving or enhancing the entity's access to key resources and relationships (including intangible ones), or the quality of those resources and relationships; if information about that aspect is material, management commentary needs to provide that information.

(c) draft guidance on risks that asks management to consider risks that could severely disrupt access to the entity's key resources and relationships (including intangible ones) in identifying key risks for the entity.

(d) draft guidance on performance and position that suggests that, in explaining how the entity has allocated capital in the reporting period, management should provide an analysis of expenditure on enhancing the entity's ability to create value and generate cash flows, for example, expenditure on research and development. This is because some expenditure on intangible resources and relationships may be recognised in the entity's financial statements as an expense rather than included in the measurement of a recognised intangible asset

Challenges and issues to be considered in identifying possible solutions

93 Anchoring the reporting objective on the notions of value creation and entity's ability to generate cash flows is consistent with the approach retained for EFRAG's research.

94 As such, this initiative is promising as it may contribute to innovate and modernise the information provided in management commentary. However, from a standard setting perspective it will not solve the issue, as the resulting information will remains voluntary in nature, thus it cannot provide for comparability nor will be subject to audit and enforcement.

95 Furthermore, the IASB has clarified that the MCPS will remain a principle-based document that will not provide detailed reporting requirements or suggest KPIs. Instead it is expected that the MCPS will set as general objectives and principles and illustrate how these principles and objectives could be reached.

Appendix 3 Research paper: Accounting for Intangible Assets: Suggested Solutions

96 At the IASB's Research Forum on 2 November 2020 a research paper Accounting for Intangible Assets: Suggested Solutions, authored by Richard Barker(Oxford University); Andrew Lennard, (UK FRC); Stephen Penman (Columbia University) and Alan Teixeira (Deloitte UK and University of Auckland) was presented.

97 The paper is based on the following premises

(a) The value of intangible assets cannot be fully communicated through the balance sheet only as intangible resources are generally employed jointly in creating value and generating cash flows and, with few exceptions there are no stand-alone values for intangibles such as knowledge capital, human capital, organisation capital.

(b) Asset recognition in the balance sheet must not be seen alone but one should also consider the effect (mismatches…) on the income statement, for the income statement conveys information about the jointly used intangibles.

(c) Earnings (in the income statement) is a summary number from using assets jointly to generate value. Thus, the accounting for assets in the balance sheet must be determined with the effect on the income statement in mind.

(d) Amortisation of capitalised (intangible) assets can upset the income statement as a communication of the value from using assets jointly. That effect increases with the amount of uncertainty about investment outcomes

(e) The tangible or intangible nature of a resource is not per se a pertinent attribute that is useful in developing different accounting requirements. There are tangible and intangible assets with indefinite lives, including land, creative works, digital currencies and brands. Some machinery and natural resources are able to produce only a defined number of units, and a licence might give the holder the right to a defined number of uses of an (intangible) asset.

98 The paper identifies conceptually four possible 'solutions' to account for internally generated intangibles which all have advantages and drawbacks. Mismatching in the income statement is inevitable and the issue in accounting for intangible assets is the minimisation of that mismatching to preserve the income statement. The four possible 'solutions are':

(a) Expense all as incurred;

(b) Recognise as an asset;

(c) Conditional capitalisation; and

(d) Threshold for capitalisation

Expensing intangibles

99 This is the default accounting when intangibles are not separately identifiable.

100 For separately identifiable investment

(a) Expensing responds to (future) mismatching, and asset overstatement, under conditions of high outcome uncertainty

(b) Yet expensing can also lead to mismatching that frustrates valuation based on earnings

(c) Separate income statement presentation can alleviate this frustration

101 The authors consider that the immediate expensing of investment in intangible assets to the income statement, as in much of current practice, upsets the income

calculation, failing to differentiate expenditure that supports current revenues from that which is intended to generate future revenues (investment).

Capitalising intangibles

102 This approach requires the intangibles to be separately identifiable. However, many expenditures are made jointly with current expenses and it is very difficult to separate them (e.g. expenditure in marketing or training of staff).

103 Futhermore, defining stand-alone value is problematic because intangibles are used jointly to create value

104 Recognising all intangible assets on the balance sheet, results in mismatches face the same issue: the income statement is affected by subsequent amortisation and impairments and amortisation and impairments may also result also in mismatched earnings and uninformative income statements. In the presence of high outcome uncertainty, there is income statement mismatching, either arbitrary amortisation or (expected) impairment.

105 Current accounting limits the recognition of intangibles to expenditures made. Recognition of an internally generated intangibles raises the question of the counterparty (credit entry) to recognise.

Threshold for capitalisation

106 Mismatching in the income statement is inevitable and the issue in accounting for intangible assets is the <u>minimisation of that mismatching to preserve the income statement.</u>

107 The solution is not to capitalise all investments to the balance sheet.

108 The determining feature to consider is the degree of uncertainty about the future outcomes and therefore the ability to establish an ex ante amortisation schedule with low probability of an impairment. The uncertainty feature suggests, for the authors of the research, a solution that books an asset to the balance sheet when an uncertainty threshold is satisfied. That requires the specification of a threshold that is operational.

109 The authors suggest to recognise an asset when an ex ante amortisation schedule can be established which, based on evidence, results in low ex post mismatching than other approaches. In their view this is a ‘balance sheet recognition in the service of providing information via the income statement’ and this would align with the concept of control in the Framework.

110 Therefore to be recognised any asset would need to be able to identify a means for allocating its consumption to appropriate periods, to yield an income statement that shows the revenues the assets generate and the consumption of those assets—a measure of value added from the investment.

111 Two other accounting features are suggested to make the approach work:

(a) There has to be an investment expenditure for balance sheet recognition and;

(b) That expenditure must be separately identifiable from transactions. Contrary to IAS 38 which apply specific prohibition rules to certain intangibles, separability is understood as a principle.

112 The authors also noted that the importance of the income statement in the proposed solution does not mean that the balance sheet is unimportant. It conveys information about investments that management has concluded will generate cash flows in the future. The income statement and the balance sheet work ‘hand-in-hand’, which is the essence of the double-entry model.

Conditional capitalisation

113 Under this approach, investments that do not meet a threshold for capitalisation will be expensed. However, if, as time evolves, it becomes likely that the investment will pay off, then capitalization occurs at the threshold point when, ex ante, subsequent amortization renders an informative income statement conveying value added to the investment. Under the prior solution, that would be the threshold point when, ex ante, subsequent amortisation renders an informative income statement conveying value added to the investment.

114 The accounting for intangibles under conditional capitalisation could work as follows:

(a) Expenditures (in research, for example) are expensed (or impaired) immediately to indicate their relative uncertainty, but to a separate part of the income statement so not to be confused with matching expenses.

(b) If the threshold for recognition is established, an asset is recognised then subsequently amortised (with low matching error) against revenue, rendering value-adding earnings from the investment.

(c) The accumulated balance of the expensed investment account could include disclosure of the costs associated with investments that have been abandoned, informing an investor of successes, failures and the expenditure related to investments still being pursued.

115 Such approach would also align with off-balance sheet disclosure.

116 It was noted IFRS permits conditional capitalisation through the requirement to reverse impairments for all assets, including intangibles, except goodwill, if the recoverable amount increases.

117 An illustration of ‘conditional capitalisation can be found in the pharmaceutical sector where some companies have developed practice to start manufacturing inventory before the drugs they have been developing have been approved, in anticipation of receiving that approval (pre-approval inventory). Inventory is recognised as an asset (inventory under IAS 2), but its recoverable amount is then assessed immediately. If the entity assesses that it is not probable, at the time of production, that it will recover the cost through sale the inventory is impaired to nil immediately. If (or when) the drug is approved, the impairment is reversed.